Supreme Court, U.S.
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No. _____

In the
Supreme Court of the United States

CROWN PAPER LIQUIDATING TRUST,
Petitioner,

v.

PRICEWATERHOUSECOOPERS, et al.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether 11 U.S.C. § 541(a) binds court-appointed bankruptcy trustees to personal defenses to which debtors are subject pre-petition, such that wrongdoing corporate directors and fiduciaries can escape liability by imputing their own wrongful conduct to innocent trustees.

RULE 14.1(b) STATEMENT

A list of all parties to the proceeding in the court whose judgment is the subject of this petition is as follows:

Plaintiff-Appellant: Crown Paper Liquidating Trust

Defendants-Appellees: PricewaterhouseCoopers, LLP; Merrill Lynch & Co.; Merrill, Lynch, Pierce, Fenner & Smith; Salomon Smith Barney, Inc.; McGuire, Woods, Battle & Booth; Credit Suisse First Boston (formerly, Donaldson, Lufkin & Jenrette); Fort James Corporation; Fort James Operating Company; Fort James Fiber Company; Fort James International Holdings; Ernst & Young; Clifford A. Cutchins, Stephen Hare; Robert C. Williams; E. Lee Showalter; William V. Daniel; Joseph T. Piemont; Ernest Leopold; and Houlihan Lokey Howard & Zukin.

STATEMENT PURSUANT TO SUPREME COURT RULE 29.6

Petitioner Crown Paper Liquidating Trust (the "Trust") states that the Trust does not issue stock. The Trust was formed pursuant to the Plan of Liquidation of Crown Vantage, Inc. and Crown Paper Co. Claims of creditors have not yet been reconciled. That reconciliation is not required under the Plan until some as yet undetermined time in the future. Therefore, the Trust is unaware of any public company having more than 10% interest in the funds of the Trust. However, as a representative of itself and other secured lenders, JP Morgan Chase is currently entitled to 50% of "recoveries" under a formula set forth in the Settlement Agreement executed in the bankruptcy proceedings of Crown Vantage and Crown Paper.

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Crown Paper Liquidating Trust,

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PricewaterhouseCoopers, et al.,

Respondents.

PETITION FOR WRIT OF CERTIORARI

Petitioner Crown Paper Liquidating Trust (the "Trust") respectfully petitions this Court for a writ of certiorari to review the decision of the U.S. Court of Appeals for the Ninth Circuit affirming the dismissal of the Trust's case against Crown Paper's former directors, officers and fiduciaries.

OPINIONS BELOW

The decision of the Ninth Circuit affirming, without opinion, the opinions of the District Court for the Northern District of California is attached hereto as Appendix A. The District Court's two opinions dismissing the Trust's case against Crown Paper's directors, officers and fiduciaries are published at *In re Crown Vantage, Inc.*, 2003 WL 2527821 (N.D. Cal. Sept. 25, 2003) and 2004 WL 1635543 (N.D. Cal. July 12, 2004) and are attached as Appendices B and C, respectively.

JURISDICTION

The decision of the Ninth Circuit affirming the dismissal of the Trust's action was entered on August 9, 2006, and the Trust's petition for rehearing and for rehearing *en banc* was denied on September 20, 2006 (Appendix D). This petition is timely under 28 U.S.C. § 2101 and Supreme Court Rules 13.1 and 13.3 because it is being filed within 90 days of the date the Court of Appeals denied the Trust's petition for rehearing. This Court's jurisdiction is invoked under 28 U.S.C. § 1254.

STATUTES INVOLVED

11 U.S.C. § 541(a), defining the property of the estate in bankruptcy and ostensibly binding court-appointed trustees to defenses to which debtors were subject pre-petition, including the personal defense of *in pari delicto*. A copy of 11 U.S.C. § 541(a) is attached as Appendix E.

STATEMENT OF THE CASE

In 1994, the James River Corporation ("JRC") was on the brink of insolvency.[1] JRC had hundreds of millions of dollars of underperforming assets which continued to lose money as they became further impaired. In conjunction with Crown's lawyers, financial advisors and auditors, JRC concocted a scheme to solve its

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[1] The above facts are taken from the Trust's complaint and the District Court's opinion, 2003 WL 2527821, at *1-4. Because the Trustee's case was dismissed on the pleadings, the allegations set forth in the complaint must be taken as true. *SEC v. Edwards*, 540 U.S. 389, 391 (2004).

financial problems. In March 1995, JRC formed Crown Vantage and Crown Paper. Crown Paper was wholly owned by Crown Vantage which was, in turn, wholly owned by JRC. Under JRC's scheme, Crown would be the entity to which JRC would transfer its underperforming assets and growing liabilities and from which JRC planned to take some $500 million in cash. Crown's stock would then be "spun off" to JRC's shareholders and Crown would become a separately traded public company.

In order to effectuate this plan, JRC placed six of JRC's own directors and employees on the Crown board of directors. Three independent board members were also appointed. But, in order to secure the approval of the independent board members, the JRC directors and their cohorts had to conceal from them the fact that the transaction would render Crown insolvent and doomed to failure as a stand-alone company. On August 15, 1995, the Crown boards heard presentations from JRC and Crown's financial advisors and lawyers, all of whom falsely represented to Crown that after the transaction, Crown would be solvent and viable. As a result of this fraud, the Crown boards, including the independent board members who had been lied to, approved the transaction.

First, JRC transferred its unwanted assets and liabilities to Crown. In exchange, JRC received all of the outstanding stock of Crown. Then, JRC caused Crown to enter into a $350 million credit facility and to undertake a $250 million high-yield Note Offering. Next, all of the common stock of Crown was "spun off" to the shareholders of JRC. Finally, three days after it ceased to be Crown's sole shareholder, JRC took the net proceeds

from the credit facility and Note Offering in the total amount of $484.9 million.

Crown's debt slowly choked the life out of it. At the time it filed for protection on March 15, 2000, Crown was insolvent by well over $1 billion. On November 22, 2001, the bankruptcy court for the Northern District of California approved the formation of the Crown Paper Liquidating Trust. On March 14, 2002, the Trust filed this case.

On September 25, 2003, the U.S. District Court for the Northern District of California dismissed Crown's case "to the extent the claims were based on conduct occurring while JRC was Crown's sole shareholder." (2003 WL 25257821, *10.) The Court reasoned that "where a sole shareholder is a participant in the wrongdoing, an allegation that independent or innocent directors could have taken steps to stop the wrongful conduct is insufficient to avoid the bar of *in pari delicto*." (*Id.* at *9.) The wrongful conduct of Crown's directors, officers and fiduciaries was then imputed to the Trust and the case was dismissed on *in pari delicto* grounds. The District Court did not distinguish among the various defendants and dismissed claims brought not only against third party fiduciaries – the lawyers, financial advisors and accountants who assisted in the fraud – but also those Crown directors sued by the Trust. The District Court allowed the defendant directors to set up *their own* wrongdoing, impute that wrongdoing to the Trust, and thereby avoid liability.

On July 12, 2004, the District Court dismissed the rest of the complaint, without leave to amend, concluding that a corporation, "after its ownership is transferred to

new parties" is still bound by the knowledge it acquired before the transfer. (2004 WL 16355543, *7.) Finally, the District Court ordered the Trust to pay attorneys fees to certain defendants in the amount of $1,600,000.

On appeal, the Ninth Circuit affirmed the District Court decisions without opinion. The Trust then filed a petition for rehearing and for rehearing *en banc*, which the Ninth Circuit denied, again without opinion, on September 20, 2006.

REASONS FOR GRANTING THE WRIT

This Court has held that where important public policies are advanced by litigation under certain federal statutes--such as the antitrust and securities laws – the equitable defense of *in pari delicto* cannot be used to defeat those policies. Such is the case in bankruptcy, where the Court has noted that bankruptcy trustees serve a public purpose vital to the bankruptcy system: By unearthing corporate fraud, trustees are able to maximize the value of the bankrupt's estate for the benefit of creditors. These purposes are defeated when courts apply defenses personal to the debtor to non-culpable trustees.

The Ninth Circuit's decision in this case is unprecedented in holding that corporate directors, officers and fiduciaries may set up *their own* wrongful conduct, impute that wrongdoing to a court-appointed bankruptcy trustee, and thereby immunize themselves from liability via the doctrine of *in pari delicto*. Other circuit and district courts have held precisely the opposite. This Court's review is important to resolve not only this conflict, but to decide whether the Bankruptcy Code itself

(11 U.S.C. § 541(a)) mandates that trustees should be subject to an *in pari delicto* defense in litigation against corporate fiduciaries.

Petitioner shows here that neither the Code's language nor its legislative history warrant the result reached below and in other federal courts. Common sense, logic and public policy support the allowance of trustee lawsuits free from the *in pari delicto* defense. The Petition should be granted to resolve these conflicts among the federal courts and to affirm that the important public purposes served by bankruptcy trustees require that defenses personal to the debtor should not be attributed to the trustee.

I. THE DECISIONS BELOW ARE OF GREAT IMPORTANCE, HAVING WIDESPREAD SIGNIFICANCE TO THE ADMINISTRATION OF THE UNITED STATES BANKRUPTCY SYSTEM.

Whatever one may say about the health of the U.S. economy, individuals and corporations are availing themselves of the bankruptcy system more than ever. The bankruptcy case load is the largest in the federal court system. Every year since 1996, more than one million individuals and businesses have filed for bankruptcy protection. (U.S. Dept. of Justice, *United States Trustee Program, Annual Report for 2005*, p. 9 ("*USTO Report*").) The year 2005 witnessed the largest number of filings in U.S. history – 2,078,415. Of these, 2,039,214 were consumer bankruptcies, as many individuals rushed to beat the October 17, 2005 effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), which tightened requirements

for Chapter 7 filings and shifted more individual debtors to Chapter 13 repayment plans. (Kerry A. Mastroianni, ed., *The 2006 Bankruptcy Yearbook & Almanac* (Boston, 2006), pp. 4, 25 ("*2006 Yearbook*").) Of this staggering number, 39,401 filings in 2005, were business filings, more than any year since the Enron catastrophe of 2001. (*Id.*, p. 4). Of business filings, 28,006 were Chapter 7 liquidations. (*Id.*, p. 2.) Eighty-six public companies filed for protection in 2005 and eleven of those filings involved companies having assets of more than $1 billion. (*Id.*, p. 29.).

Although the three largest corporate bankruptcies in U.S. history – measured in terms of company assets – occurred in 2001-02,[2] fully 20% of the largest public bankruptcies of all time occurred in 2005: Refco, Inc. (6th; $33,333,000,000); Calpine Corp. (10th; $27,216,000,000); Delta Airlines, Inc. (12th; $21,801,000,000); Delphi Corp. (19th; $16,593,000,000); and Northwest Airlines Corp. (24th; – $14,042, 000,000).[3]

No less troubling, the dollar amount of distressed and defaulted public and private debt increased significantly in 2005, to more than $100 billion over the 2004 figure. Of a total of $703 billion of such 2005 debt, $219.7 billion represented public company debt (as

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[2] WorldCom, Inc. (1st; $103,900,000,000); Enron Corp. (2nd; $63,392,000,000); and Conseco, Inc. (3rd; $61,392, 000,000). *2006 Yearbook*, p. 53.

[3] Refco's Chapter 11 filing followed allegations that Refco's former CEO and Board Chairman committed securities fraud by hiding $430,000,000 from investors who funded Refco's August 2005 IPO. *2006 Yearbook*, p. 71.

compared to $188.6 billion in 2004), and private company distressed and defaulted debt amounted to $483.3 billion (as compared to $415 billion in 2004). (*Id.*, p. 281.)

Primary responsibility for the administration of the U.S. bankruptcy system lies with the Department of Justice and, specifically, the United States Trustee Program, formed pursuant to the Bankruptcy Act of 1978. The United States Trustee's Office ("USTO") employs 1,150 people, including attorneys, financial analysts and support staff. (*USTO Report*, p. 10.) The USTO Program is entirely self-funded through filing and user fees paid by bankruptcy debtors. (*Id.*, p. 10.) Among its many functions, the USTO is charged with the generation of statistical reports, data and automation systems related to the bankruptcy system, credit counseling and debtor education, implementation of bankruptcy legislation, such as the 2005 BAPCPA, and the initiation of actions calculated "to root out and remedy debtor fraud and abuse" of the bankruptcy system by seeking a denial of the discharge of debts or dismissal of cases. (*Id.*, p. 19.) In 2005, the USTO filed 1,301 complaints objecting to or seeking revocation of discharge and took no less than 50,700 civil enforcement and other actions to remedy abuses of the bankruptcy system. (*Id.*)

Because of its policing and administrative functions, the USTO is *not* well-equipped to recompense creditors of corporations that are rendered insolvent as a result of management fraud. For this purpose, the USTO relies largely – as it must – on the appointment of private trustees. Under 11 U.S.C. § 1104(a)(1), the bankruptcy court is empowered to order the appointment of a trustee, on the request of a party in interest or the USTO "for cause, including fraud, dishonesty, incompetence or gross

mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, ..." In Chapter 7 liquidations, 11 U.S.C. § 702 enables creditors to elect a trustee. Statistics for 2005 disclose that bankruptcy courts granted at least 83% of motions brought by the USTO or another party for the appointment of a private trustee. (*USTO* Report, p. 36.)

The USTO Program supervises approximately 1,400 private trustees – more than the entire number of USTO employees – to administer bankruptcy estates and distribute payments to creditors in cases filed under Chapters 7, 12 and 13. In 2005 alone, private Chapter 7 trustees closed nearly 54,000 asset cases – the highest number ever – generating more than $1.82 billion in funds. (*USTO Report*, pp. 43, 64). In Chapter 13 cases, private trustees collected some $5.4 billion in 2005, averaging $28.4 million per trustee. (*Id.*, p. 43.)

There can be no doubt, then, that private trustees perform a vital role in the U.S. bankruptcy system. For this reason, court decisions that place limitations on the ability of private trustees to rectify corporate fraud and mismanagement – particularly artificial limitations unrelated to the conduct of trustees – represent a severe impediment to the efficient working of the bankruptcy system.

II. THE DECISIONS BELOW CONCERN THE CONSTRUCTION OF A MAJOR FEDERAL STATUTE IN A MANNER CALCULATED TO FRUSTRATE THE BANKRUPTCY CODE'S GOALS OF (i) UNCOVERING CORPORATE INSIDER FRAUD AND THEREBY (ii) MAXIMIZING THE VALUE OF THE BANKRUPT'S ESTATE.

More than twenty years ago, this Court recognized the critical role played by private trustees in the bankruptcy system. In *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352 (1985), the Court noted that "the powers and duties of a bankruptcy trustee are extensive. Upon commencement of a case in bankruptcy, all corporate property passes to an estate represented by the trustee. 11 U.S.C. §§ 323, 541. The trustee is 'accountable for all property received,' §§ 704(2), 1106(a)(1), and has the duty to maximize the value of the estate, *see* § 704(1)." Among other things, the Court noted, the trustee "is directed to investigate the debtor's financial affairs, U.S.C. §§ 704(4), 1106(a)(3), and is empowered to sue officers, directors, and other insiders to recover, on behalf of the estate, fraudulent or preferential transfers of the debtor's property, §§ 547(b)(4)(B), 548." (*Id.*)

In one trenchant sentence, the Court emphasized two fundamental goals of the Bankruptcy Code served by the appointment of private trustees: "In seeking to maximize the value of the estate, the trustee must investigate the conduct of prior management to uncover and assert causes of action against the debtor's officers and directors. *See generally* 11 U.S.C. §§ 704(4), 547, 548." (*Id.* at 353.) In the particular context of the

Weintraub case, which involved the issue of who held the attorney-client privilege in the event of insolvency and the appointment of a trustee, the Court noted that, "the Code's goal of uncovering insider fraud would be substantially defeated if the debtor's directors were to retain the one management power that might effectively thwart an investigation into their own conduct." (471 U.S. at 353-54.)

Since this Court has recognized that bankruptcy trustees perform vital functions under the Bankruptcy Code - uncovering insider fraud and thereby maximizing the value of the estate - it may well be asked how the decisions of the courts below foster or promote these goals. It is apparent that far from promoting these recognized Bankruptcy Code goals, the decisions below actually frustrate them. If a trustee's action is barred by the pre-petition wrongdoing of the debtor's own management, obviously, the trustee will not be able to recover for the fraud of such corporate insiders and those who assist them. Since, in the case of *in pari delicto*, wrongdoing of the corporate insiders is acknowledged in order to advance the defense, wrongdoers are rewarded for their wrongful conduct and the estate - and, by extension, the creditors - suffer. That result is particularly troubling since it must be acknowledged that the trustee, and his ultimate beneficiaries, the creditors, are themselves in no way culpable. The wrongdoers are rewarded; the defrauded are punished. That result is the antithesis of the Bankruptcy Code goals acknowledged by this Court in *Weintraub*.

III. SUPREME COURT CONSIDERATION IS NECESSARY IN ORDER TO RESOLVE CONFLICTS AMONG THE FEDERAL COURTS CONCERNING APPLICATION OF 11 U.S.C. § 541(a) AND THE DEFENSE OF *IN PARI DELICTO* TO BANKRUPTCY TRUSTEES.

A. The Decisions Below Conflict With Those Of Other Federal Courts Holding That Corporate Fiduciaries Cannot Set Up Their Own Wrongdoing As A Defense To Liability.

Typically, the *in pari delicto* defense is asserted by non-insider defendants who allege the wrongdoing of the corporation's directors and officers to insulate themselves from liability. But here, the Ninth Circuit allowed these very insiders – the directors, officers, lawyers and other fiduciaries of Crown – to attribute their own wrongdoing to the Trustee and, through *in pari delicto*, immunize themselves from liability. In so holding, the lower courts here departed from the decisions of nearly every other federal court: insiders and fiduciaries cannot impute their own wrongdoing to a trustee and thereby avoid liability on *in pari delicto* grounds.

Many federal courts – including this Court – have held that corporate insiders and fiduciaries may not set up their own wrongdoing as a defense against a bankruptcy trustee. *See, e.g., Pepper v. Litton*, 308 U.S. 295, 307 (1939) ("While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the

trustee."); *In re The Mediators*, 105 F.3d 822, 826-27 (2d Cir. 1997); *Ash v. Georgia-Pacific Corp.*, 957 F.2d 432, 436 (7th Cir. 1992); *Meyers v. Moody*, 693 F.2d 1196, 1208 (5th Cir. 1982); *In re Healthsouth Shareholders Litig.*, 845 A.2d 1096, 1107 (Del. Ch. 2003) (it is "transparently silly" for [director] Scrushy to "wield the doctrine of *in pari delicto* to escape liability ... [T]he *in pari delicto* doctrine has been rejected in situations when corporate fiduciaries seek to avoid responsibility for their own conduct vis-à-vis their corporations."); *In re Walnut Leasing Co.*, 1999 WL 729267, at *5 (E.D. Pa. 1999) ("*in pari delicto* will not preclude the claims against corporate insiders. Vis-à-vis their corporations, insiders cannot avoid the consequences of their own handiwork."); *In re Hampton Hotel Investors*, 289 B.R. 563, 577, n. 23 (Bankr. S.D.N.Y. 2003) (the *in pari delicto* defense "only deals with claims against third parties. It does not proscribe actions against insiders for breach of fiduciary duty, which are properly claims of the trustee."); *In re Granite Partners*, 194 B.R. 318, 332 (Bankr. S.D.N.Y. 1996) ("*in pari delicto* bars claims against third parties, but does not apply to corporate insiders or partners. Otherwise, a trustee could never sue the debtor's insiders on account of their own wrongdoing."); *In re KDI Holdings*, 277 B.R. 493, 518 (Bankr. S.D.N.Y. 1999) ("the *in pari delicto* doctrine is inapplicable where a cause of action is brought against an insider.").

As shown in the following subsections, 11 U.S.C. § 541(a) does not mandate that the *in pari delicto* doctrine must be applied to innocent bankruptcy trustees, charged with uncovering corporate fraud and maximizing the value of the estate for the benefit of innocent creditors. However, even if applied by third-party non-fiduciaries, the defense should never be invoked by corporate insiders,

directors, officers or other fiduciaries of the corporation. To empower these insiders and fiduciaries to set up their own wrongdoing, impute that wrongdoing to the trustee and immunize themselves from liability is to turn the *in pari delicto* doctrine on its head. The Court should grant the petition to correct this conflict between the Ninth Circuit and the courts described above.

B. It Is Not In The Public Interest To Bind Trustees To The Personal Defenses That Debtors Are Subject To Pre-Petition.

Earlier this year, this Court underscored the importance of uniformity in U.S. bankruptcy law. In *Central Virginia Cmty. College v. Katz*, ___ U.S. ___, 126 S. Ct. 990, 1004, n. 13 (2006), the Court emphasized that "unlike the Commerce Clause, the Bankruptcy Clause itself contains an affirmative limitation or restriction upon Congress' power: bankruptcy laws must be uniform throughout the United States," *quoting Railway Labor Executives Ass'n v. Gibbons*, 455 U.S. 457, 468 (1982). The Court's emphasis was justified, for "[t]he text of Article I, § 8, cl. 4, of the Constitution, ... provides that Congress shall have the power to establish 'uniform laws on the subject of Bankruptcies throughout the United States.'" (*Katz*, 126 S. Ct. at 1000.)

Despite this mandate for uniformity, the federal courts have, in the last decade, exhibited wide and conflicting differences of opinion as to the application of the *in pari delicto* defense to trustees.[4] The Trust

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[4] Unlike the federal courts, though, academics and commentators are uniform in the view that the *in pari delicto*

emphasizes here that the fundamental issue confronted by the lower courts is not *how* the *in pari delicto* doctrine should be applied under applicable state law, but rather whether the doctrine should be applied to trustees at all – that is a question of federal bankruptcy law.[5] Several bankruptcy and district courts have examined the language of the Bankruptcy Code, the legislative history behind the

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should *not* be applied to bankruptcy trustees. *See* Jeffrey Davis, *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing To Do With What is Section 541 Property of the Bankruptcy Estate*, 21 Emory Bankr. Dev. J. 519 (2005); Tanvir Alam, *Fraudulent Advisors Exploit Confusion In The Bankruptcy Code: How In Pari Delicto Has Been Perverted To Prevent Recovery For Innocent Creditors*, 77 Am. Bank. L.J. 305 (2003); Gerald L. Baldwin, *In Pari Delicto Should Not Bar A Trustee's Recovery*, 23-8 Am. Bank. Inst. J. 8 (2004); Robert T. Kugler, *The Role Of Imputation And In Pari Delicto In Barring Claims Against Third Parties*, 1 No. 14 Andrews Bankr. Litig. Rep. 13 (2004); *Making Sense Of The In Pari Delicto Defense: "Who's Zoomin' Who?"*, 23 No. 11 Bankr. Law Letter 1 (Nov. 2003).

[5] In *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 83 (1994), this Court quickly rejected the argument that federal common law, and not applicable state law, "determines whether the knowledge of corporate officers acting against the corporation's interests will be imputed to the corporation." That conclusion was clear because, as the Court noted, "there is no federal general common law." (*Id.*) However, as seen from the discussion of the federal court decisions referenced in this section, those courts that have concluded *in pari delicto must* be applied to bankruptcy trustees have reached that conclusion based on the interpretation of a federal statute – 11 U.S.C. § 541(a)(1). Thus, in the view of some federal courts that have considered the issue, application of *in pari delicto* to trustees is mandated by federal statute.

1978 Bankruptcy Act and the policy considerations animating the Code to conclude that *in pari delicto* should not be applied to bankruptcy trustees.

A good, recent example is provided by *In re Fuzion Technologies Group, Inc.*, 332 B.R. 225 (Bankr. S.D. Fla. 2005). There, the Bankruptcy Court concluded that application of *in pari delicto* to Chapter 7 liquidation trustees was illogical once wrongdoing corporate management has been removed from the scene. Quoting Judge Posner in *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995) – a case involving a receiver – the Court stated:

> [T]he wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls out now that Douglas has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the monies – for the benefit not of Douglas but of innocent investors – that Douglas had made the corporations divert to unauthorized purposes. Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated. (332 B.R. at 233.)[6]

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[6] To the same effect, *see also*, *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995). This Court also declined to apply

The *Fuzion Technologies* Court applied this logic to the bankruptcy trustee:

> Rejection of the defense is even more compelling where there is no risk that the wrongdoer will reap the reward of any damages recovered by a trustee. If the Supreme Court did not deem it inequitable for an antitrust plaintiff with unclean hands to reap a treble damage windfall, then this Court does not consider it unfair to permit a bankruptcy trustee to recover funds from third parties for the benefit of innocent creditors free from the taint of the former officer's wrongful behavior. (332 B.R. at 234.)

In reaching this conclusion, the *Fuzion Technologies* court relied on this Court's decision in *Perma Life Mufflers, Inc. v. Int'l. Parts Corp.*, 392 U.S. 134 (1968), reasoning that when application of the *in pari delicto* defense is not in the public interest, this Court has not hesitated to permit recovery by the plaintiff – even if the plaintiff engaged in improper conduct. (332 B.R. at 233.) Decided in the context of a private antitrust suit, the *Perma Life Mufflers* Court rejected the *in pari delicto* defense and held that even though the plaintiff in an antitrust suit "who reaps the reward of treble damages may be no less morally reprehensible than the defendant, ... the law encourages his suit to further the overriding public policy in favor of competition." (392 U.S. at 139.)

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a consent defense to a receiver in *McCandless v. Furlaud*, 296 U.S. 140, 159-61 (1935).

In *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), the Court extended *Perma Life Mufflers* and held that even though a tippee-violator under the Securities Act may be regarded as culpable, the public interest precluded the application of *in pari delicto* to that plaintiff because of predominant public policy goals underlying the Securities Act – "protection of the investing public and the national economy through the promotion of a 'high standard of business ethics ... in every facet of the securities industry.'" (472 U.S. at 315, *quoting SEC v. Capital Gains Res. Bur., Inc.*, 375 U.S. 180, 186-87 (1963).)

Again, in *Pinter v. Dahl*, 486 U.S. 622 (1988), the Court considered whether the *in pari delicto* defense was available in an action brought under Section 12(1) of the Securities Act of 1933, and concluded that the trial court record was insufficient to determine whether Dahl was liable as a statutory "seller" under Section 12(1). In so holding, the Court revisited its decision in *Bateman Eichler* and its elaboration of a two part test:

> [T]he *in pari delicto* defense is available "only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public." (486 U.S. at 633.)

This test is easily adapted to the bankruptcy context. First, the plaintiff-trustee bears *no* responsibility, much less "at least substantially equal responsibility," for the violations he seeks to redress against company insiders

and fiduciaries. Second, preclusion of the trustee's suit most definitely "significantly interferes" with the effective enforcement of the Bankruptcy Code since, in *Weintraub*, this Court identified the power of bankruptcy trustees to redress management fraud, and maximize the value of the estate as significant goals of the Code. Preclusion of a trustee's suit on the basis of *in pari delicto* interferes with those goals.

The Court added in *Pinter* that "[o]ne of the premises on which the *in pari delicto* doctrine is grounded is that 'denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.'" (486 U.S. at 634, *quoting Bateman Eichler*, 472 U.S. at 306.) Applying *in pari delicto* to a bankruptcy trustee turns this premise on its head; the trustee is not an "admitted wrongdoer" whose conduct needs to be deterred; he is *suing* wrongdoers whose conduct needs to be deterred.

Can it be said that the public purposes underlying the Bankruptcy Code are any less significant than those animating the antitrust and securities laws? The *Fuzion Technologies* Court thought not: "An important public purpose is served by the trustee in this case – marshalling the assets of the estate and distributing them to the creditors who suffered losses." (332 B.R. at 234.) That description of the "public purpose" underlying the trustee's role in bankruptcy is remarkably similar to the goals identified by this Court in *Weintraub* – uncovering management fraud and thereby maximizing the value of the estate for innocent creditors.

The Bankruptcy Court was certainly correct to conclude in *Fuzion Technologies* that "the trustee is the last good person who can help the creditors and ensure

that the loss is borne by those who caused it and not by innocent people." (*Id.*) Indeed, the rationale underlying this Court's decisions in *Perma Life Mufflers* and *Bateman Eichler* is far stronger in the bankruptcy context because the plaintiffs in those two decisions did have some taint of culpability. But bankruptcy trustees are, by definition, non-culpable.[7] Not only is the Trustee non-culpable, the ultimate beneficiaries of his efforts – the defrauded creditors – are themselves innocent. Thus, if this Court concludes that important public purposes are served by private trustee suits brought under the aegis of the Bankruptcy Code, then, *a fortiori*, the logic of *Perma Life Mufflers* and *Bateman Eichler* warrants the Court's consideration and reversal of the Ninth Circuit here.

Several Bankruptcy and District Courts have applied, in whole or in part, the reasoning reflected in *Fuzion Technologies*. *See, e.g., In re Latin Inv. Corp.*, 168 B.R. 1, 4 (Bankr. D.D.C. 1993) ("any policy reasons outside bankruptcy for taking pains to bar shareholders from recovery, including imputing their knowledge to the corporation, do not support limiting the ability of a trustee in bankruptcy to liquidate the debtor's assets"); *In re Plaza Mortgage & Fin. Corp.*, 187 B.R. 37, 47 (Bankr. N.D. Ga. 1995); ("Is there any reason why the rationale of the Ninth Circuit in *O'Melveny* on remand and the Seventh Circuit in *Scholes* shouldn't apply to the trustee here? ... [A] trustee in bankruptcy should be in no worse

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[7] Under 11 U.S.C. § 702, a bankruptcy trustee must demonstrate his "disinterestedness" before the court will confirm his appointment. If "disinterestedness" means anything, it must mean that the trustee is at least non-culpable in the debtor's failure. *See* 11 U.S.C. § 101(14).

position than a state or federal receiver."); *Hannover Corp. of America v. Beckner*, 211 B.R. 849, 858-59 (M.D. La. 1997); *Welt v. Sirmans*, 3 F. Supp. 2d 1396, 1402 (S.D. Fla. 1997); *In re Del-Met Corp.*, 322 B.R. 781, 828-31 (Bankr. M.D. Tenn. 2005); and *In re Jack Greenberg, Inc.*, 240 B.R. 486, 501-06 (Bankr. E.D. Pa. 1999).

C. Federal Bankruptcy, District And Appellate Decisions Conflict On The Application Of 11 U.S.C. § 541(a) And The *In Pari Delicto* Defense To Trustees.

While the above decisions make good sense from standpoints of both logic and public policy, some federal courts have rejected them, not because they are illogical or reflect poor policy, but because of a perceived requirement of the Bankruptcy Code.

Section 541(a) of the Code defines Property of the Estate:

> (a) The commencement of a case under Section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> > (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property *as of the commencement of the case*.
>
> * * *

> (7) Any interest in property that the estate acquires *after the commencement of the case*. (*See* Appendix E for full text of 11 U.S.C. § 541(a); emphasis added.)

Based on the language of 11 U.S.C. § 541(a)(1), some courts have concluded that the Code itself requires that trustees be bound by the same defenses attributable to the debtor pre-petition. The first appellate court to advance this point was the Tenth Circuit in *In re Hedged-Investments Assoc., Inc.*, 84 F.3d 1281 (10th Cir. 1996). There, the Court acknowledged that "the Seventh Circuit's reasoning in *Scholes* enjoys a certain appeal, both from doctrinal and public policy perspectives, [but] we cannot adopt it in this case." Again, the Court noted "sound reasons why it might be wise to allow an exception to this rule [binding the trustee to the debtor's defenses] in cases, such as this one, where the trustee's efforts stand to benefit hundreds of innocent investors." (84 F.3d at 1285.) However, the Court concluded, because of 11 U.S.C. § 541, "bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result ... [the trustee] urges." To the same effect, *see Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 357-59 (3d Cir. 2001); *Grassmueck v. The American Shorthorn Ass'n.*, 402 F.3d 833, 836 (8th Cir. 2005); and *Official Comm. Of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1150 (11th Cir. 2006), *cert. den.* 127 S. Ct. 45 (2006).[8]

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[8] Two other decisions, *In re Dublin Sec., Inc.*, 133 F.3d 377 (6th Cir. 1997), and *Baena v. KPMG, LLP*, 453 F.3d 1 (1st Cir.

The Tenth Circuit was certainly correct in acknowledging the logic and public policy reasons for *not* applying *in pari delicto* to trustees, but was incorrect in concluding that 11 U.S.C. § 541 "expressly" requires that the trustee inherit this defense. Section 541 says *nothing* about defenses. It does state that property of the estate includes "all legal or equitable interests of the debtor in property *as of the commencement of the case*." (Emphasis added.) But, in 1978, the Code was amended to provide that property of the estate also includes "any interest in property that the estate acquires after the commencement of the case."[9] In short, "property of the estate" includes not only property of the debtor "as of the commencement of the case," it also includes any interest in property acquired "after the commencement of the case." Therefore, the rationale of the Tenth Circuit in *Hedged-Investments* is undermined by the very language of the Code. Put simply, since the 1978 Bankruptcy Act, property of the estate is no longer limited to that property existing as of the commencement of the case; it expressly includes property acquired *after* commencement of the case. Therefore, the plain language of § 541, rather than requiring application of *in pari delicto* to trustees, fails as a rationale for doing so.[10]

2006), applied the *in pari delicto* defense to trustees based on the pre-petition wrongdoing of the debtor, but neither case involved a discussion of the propriety of applying *in pari delicto* to a trustee under federal bankruptcy law.

[9] Section 11 U.S.C. § 541(a)(1) and U.S.C. § 541(a)(7) are, of course, on equal standing; neither section carries greater weight than the other.

[10] Here, the Trust emphasizes that it is not claiming that the causes of action it asserts against Crown's directors, officers

Even if the 1978 change to § 541(a) were regarded as ambiguous in light of the addition of sub-section 7, the legislative history attending the 1978 Bankruptcy Act makes clear that Congress did not intend that personal defenses attributable to the debtor bind the trustee. In describing the final amendments that conformed the House and Senate bills, Congressman Edwards of California stated:

> *[A]s § 541(a)(1) clearly states*, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate *except to the extent that defenses which are personal against the debtor are not effective against the estate*. (Emphasis added.)

124 CONG. REC. H11,1096 (Daily ed. Sept. 28, 1978); 124 CONG. REC. H32383, Vol. 124 p. 24.

While neither the express language nor the legislative history of the 1978 Bankruptcy Act support the conclusion of those courts applying *in pari delicto* to trustees, other provisions of the Code – no more or less specific than § 541(a) – have generated decisions declining to apply the defense to trustees. In *In re Personal & Bus.*

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and fiduciaries arose post-petition; rather, the Trust contends that as a *rationale* for binding trustees to pre-petition defenses attributable to the debtor, § 541(a) does not withstand scrutiny. This is because, read as a whole, § 541(a) defines property of the estate to include not only property existing as of the petition date, but also property acquired post-petition.

Ins. Agency, 334 F.3d 239, 246 (3d Cir. 2003), the court held that the post-petition removal of fraudulent managers can be considered to overcome the *in pari delicto* defense in an action under § 548 of the Bankruptcy Code. Similarly, the Second Circuit in *In re Leasing Consultants, Inc.*, 592 F.2d 103, 110 (2d Cir. 1979), held that the *in pari delicto* defense can be disregarded when the trustee brings an action under § 544(b) of the Code. Again, in *In re Porter McEleod*, 231 B.R. 786, 793-95 (D. Colo. 1999), the District Court declined to apply *in pari delicto* to claims being brought by a Chapter 7 trustee under § 544(a) against third party advisers of the debtor.

Examination of these decisions, involving the so-called avoidance and strong-arm provisions of the Code, demonstrates that they are neither more nor less specific regarding defenses attributable to trustees than is § 541(a). Put simply, courts rendering decisions under §§ 544(a), 544(b), and 548 have held that it is appropriate to consider post-petition circumstances – the appointment of a trustee – under these sections, but not under § 541.[11]

The Court should grant the Trust's petition in order to reconcile these conflicting decisions among the

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[11] It must be noted that this Court in *Bank of Marin v. England*, 385 U.S. 99 (1966), indicated that generally a trustee is bound by the same defenses as the debtor in whose place he stands. However, the *Bank of Marin* case was decided twelve years before the new Bankruptcy Act of 1978, adding sub-section 7 to 11 U.S.C. § 541(a), and before the legislative history of the new Act demonstrating that the drafters did not intend for personal defenses, like *in pari delicto*, to be applied to bankruptcy trustees.

federal courts regarding the application of *in pari delicto* to trustees.

IV. APPLYING *IN PARI DELICTO* TO BANKRUPTCY TRUSTEES IS INCONSISTENT WITH THE RATIONALE BEHIND IMPUTATION LAW AND ENCOURAGES CORPORATE MALFEASANCE.

The Trust has shown that private trustee lawsuits against corporate malefactors serve important deterrent and remedial purposes in bankruptcy law. Such suits have a deterrent purpose because they provide a check on the wrongdoing of corporate insiders and fiduciaries. And they serve the remedial purpose of providing creditors with the best opportunity available for recovering losses sustained at the hands of corporate bad actors..

In the present case, the insiders of JRC, its lawyers, auditors and financial advisers, devised a clever structure to defraud those lenders and Note holders who invested in Crown. To allow these wrongdoers to impute their own wrongful conduct to an innocent trustee and his innocent creditors, and thereby escape liability, is to encourage such corporate machinations.

Equally troubling is the notion that although *in pari delicto* is an equitable doctrine, sensitive to the facts and often adapted to achieve equitable results, that doctrine is applied here in a distinctly inequitable fashion; reliance on an implicit point – that 11 U.S.C. § 541(a)(1) mandates that a trustee be bound by all those defenses existing at the commencement of the case – here produces a markedly inequitable result. That result is definitely not found in the express language of § 541(a)(1) and the lower

federal courts should not be required to adhere to a construction that is not explicit in the statute. In fact, there is no language in § 541(a), or anywhere else in the Bankruptcy Code, that mandates that trustees be bound to those same defenses as debtors. Indeed, this Court has considered post-petition events in defining "property of the estate" under the Code. *See Segal v. Rochelle*, 382 U.S. 375 (1966).

This Court has also held that "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." *Pepper v. Litton*, 308 U.S. 295, 304 (1939). Equity has been defined as "the recourse to principles of justice to correct or supplement the law as applied to particular circumstances." Black's Law Dictionary, 560 (7th ed. 1999). It is also universally recognized that *in pari delicto* is an equitable defense, a concept developed in order to *preclude* wrongdoers from profiting from their conduct. The doctrine has now been contorted beyond all recognition. Now, wrongdoers are advancing this defense to protect *themselves* from a person – a trustee – who is not a wrongdoer and who represents people – creditors – who are also innocent.

The decision of the Ninth Circuit here, and those of other federal courts that have enabled wrongdoers to invoke the *in pari delicto* doctrine against trustees, is not supported by common sense, logic, equity or the language or legislative history of the Bankruptcy Code. This Court should grant the Trust's petition, reconcile the conflicts among the federal courts, and do equity.

CONCLUSION

For the foregoing reasons, Petitioner respectfully requests that a writ of certiorari be granted.

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APPENDIX

APPENDIX

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APPENDIX A

FILED
AUG 09, 2006
CATHY A. CATTERSON
CLERK, U.S. COURT OF APPEALS

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 04-16597
D.C. No. CV-02-03836-MMC

CROWN PAPER LIQUIDATING TRUST,

Plaintiff – Appellant,

v.

PRICEWATERHOUSECOOPERS LLP; et al.,

Defendants – Appellees.

No. 05-15469
D.C. No. CV-02-03836-MMC

CROWN PAPER LIQUIDATING TRUST,

Plaintiff – Appellant,

v.

PRICEWATERHOUSECOOPERS LLP; et al.,

Defendants – Appellees.

No. 05-015751
D.C. No. CV-02-03836-MMC

CROWN PAPER LIQUIDATING TRUST,

Plaintiff – Appellant,

v.

PRICEWATERHOUSECOOPERS LLP; et al.,

Defendants,

And

HOULIHAN LOKEY HOWARD & ZUKIN; et al.,

Defendants – Appellees.

No. 05-15775
D.C. No. CV-02-03836-MMC

CROWN PAPER LIQUIDATING TRUST,

Plaintiff - Appellee,

v.

CLIFFORD CUTCHINS; et al., ORDER*

Defendants - Appellants,

And

PRICEWATERHOUSECOOPERS LLP, f/k/a COOPERS & LYBRAND; et al.,

Defendants.

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

Appeal from the United States District Court
for the Northern District of California
Maxine M. Chesney, District Judge, Presiding

Argued and Submitted July 25, 2006
San Francisco, California

Before: T.G. NELSON, SILVERMAN, and RAWLINSON, Circuit Judges.

We affirm for the reasons set forth in the well-reasoned district court orders filed on September 25, 2003, July 12, 2004, March 28, 2005 and March 30, 2005, in this consolidated appeal.

AFFIRMED.

APPENDIX B

United States District Court,

N.D., California

In re: CROWN VANTAGE, INC., Debtor.

No. 02-3836MMC.

Sept. 25, 2003.

ORDER GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTIONS TO DISMISS; DEFERRING RULING ON CERTAIN ISSUES

MAXINE M. CHESNEY, J.

(Docket Nos. 83, 84, 86, 89, 90, 96, 97)

*1 The above-titled consolidated proceeding consists of three matters that previously were pending in the United States Bankruptcy Court for the Northern District of California, as part of *In re Crown Vantage, Inc.*, a Chapter 11 proceeding filed by Crown Vantage, Inc. ("Crown Vantage") and Crown Paper Company ("Crown Paper").[1] The three matters are: (1) *Fort James Corporation v. Crown Vantage, Inc., et al.*, C 02-3838 ("the Fort James case"); (2) *Crown Paper Co., et al., v. Fort James Corp., et al.*, C 02-3839 MMC ("the Crown

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[1] By orders filed April 23, 2002 and August 8, 2002, the bankruptcy court certified the three matters to the District Court for withdrawal of the reference pursuant to Bankruptcy Local Rule 9015-2, and on April 16, 2003, the consolidated proceeding was reassigned to the undersigned.

Vantage case"); and (3) *Crown Paper Liquidating Trust v. PricewaterhouseCoopers, et al.*, C 02-3836 MMC ("the Liquidating Trust case").

Before the Court is the motion of defendants Fort James Corporation, Fort James Operating Company, Fort James Fiber Company, and Fort James International Holdings, Ltd. (collectively, "Fort James") to dismiss the First Amended Complaint in the Crown Vantage case ("the FJ FAC"). Also before the Court are nine motions to dismiss the First Amended Complaint in the Liquidating Trust case ("the PWC FAC"), filed, respectively, by the following defendants: (1) PricewaterhouseCoopers LLP, f/k/a Coopers & Lybrand ("PWC"); (2) Ernst & Young LLP ("E & Y"); (3) McGuire Woods LLP, as successor to McGuire Woods Battle & Boothe, LLP ("McGuire Woods"); (4) Merrill Lynch & Co., Merrill Lynch Pierce Fenner & Smith, (collectively, "Merrill Lynch") and Salomon Brothers ("Salomon"); (5) Credit Suisse First Boston Corporation, as successor to Donaldson, Lufkin & Jenrette ("DLJ"); (6) Houlihan Lokey Howard & Zukin ("Houlihan Lokey"); (7) Ernest Leopold ("Leopold"); (8) Clifford Cutchins ("Cutchins"), Stephen Hare ("Hare"), and Robert C. Williams ("Williams"); and (9) William Daniel ("Daniel"), Joseph T. Piemont ("Piemont"), and E. Lee Showalter ("Showalter").

On August 15, 2003, the motions came on regularly for hearing, at which time all parties appeared through their counsel of record. Having considered the papers filed in support and in opposition to the motions, and the arguments of counsel, the Court rules as follows.

FACTUAL BACKGROUND

Crown's[2] claims arise out of a series of transactions, which Crown refers to as the "Spin," and from the aftermath of those transactions. In the pleadings, Crown defines the "Spin" as "a scheme by Fort James [ ] to unload vastly over-valued but under-performing assets onto Crown, and to cause Crown to borrow well over half a billion dollars, all of which monies were then taken by Fort James, while Crown remained obligated to pay on the loans." (*See* FJ FAC ¶ 627; *see also* PWC FAC ¶¶ 12-17.)[3]

The following facts, taken from the FJ FAC and from the PWC FAC, are assumed true solely for the purposes of the motions to dismiss.

In 1994, defendant Fort James' predecessor, James River Corporation ("JRC"), was "on the brink of insolvency." (FJ FAC ¶¶ 5, 101; PWC FAC ¶¶ 2, 106.) In March 1995, defendant McGuire Woods, a law firm whose

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[2] Plaintiffs refer to Crown Vantage and Crown Paper "interchangeably" and "collectively" as "Crown," except where necessary to differentiate between them. (*See* FJ FAC ¶ 4; PWC FAC ¶ 21.) For the purposes of this order, the Court will refer to plaintiffs as "Crown," except where necessary to differentiate between them.

[3] At the hearing, Crown expanded on its definition of the "Spin" by explaining that, in its view, the "Spin" consisted of four transactions, occurring when: (1) Fort James predecessor, James River Corporation, transferred assets and liabilities to Crown Paper, in exchange for Crown Paper stock; (2) Crown Paper borrowed money from third parties; (3) James River Corporation obtained from Crown Vantage pay-in-kind notes; and (4) Crown transferred cash to James River Corporation.

clients included JRC and Crown, formed Crown Vantage and Crown Paper as Virginia corporations, being aware of JRC's financial situation and intending that Crown would be "the dumping ground of JRC's unwanted assets and liabilities." (FJ FAC ¶¶ 21, 131; PWC FAC ¶¶ 24, 136.) Crown Vantage was a "publicly traded holding company owning 100% of Crown Paper's outstanding stock" (PWC ¶ 3), and JRC became the "sole shareholder" of Crown Vantage. (FJ FAC ¶¶ 260(a), 630; PWC FAC ¶¶ 265(a).) JRC elected insiders of JRC to the Crown Board of Directors, and those "insider directors" were under control of, and acted for the benefit of, JRC. (FJ FAC ¶ 133; PWC FAC ¶ 138.) Additionally, three "independent" directors were appointed to the Crown Board. (FJ FAC ¶ 167; PWC FAC ¶ 172.) On August 15, 1995, the Crown Board of Directors, including the "independent" directors, voted to enter into transactions "related to the Spin," (FJ FAC ¶¶ 208, 242; PWC FAC ¶¶ 213, 247) and, on August 25, 1995, the "spin-off" of Crown from JRC occurred. (FJ FAC ¶ 696.)

*2 In planning and executing the Spin, JRC had "sole and complete decision-making power." (FJ FAC ¶ 134; PWC FAC ¶ 139.) Under the transactions comprising the Spin, JRC transferred to Crown assets that were "depleted" and "extremely overvalued." (FJ FAC ¶¶ 159(a), 400; PWC FAC ¶¶ 164(a), 405.) JRC also caused Crown to transfer to JRC $551,200,000 in cash,[4] (FJ FAC ¶ 252; PWC FAC ¶ 257), caused Crown to issue $100 million in "Senior Pay-in-Kind" ("PIK") Notes to JRC, (*id.*), and

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[4] As a result of alleged misrepresentations made by JRC to a group of banks, Crown had obtained a "credit facility," comprising two "terms loans," and a "revolving line of credit." (FJ FAC ¶ 166; PWC FAC ¶ 171.)

caused Crown to enter into an agreement under which Crown became liable for "numerous contractual and other liabilities" of JRC. (FJ FAC ¶ 254; PWC FAC ¶ 259.)[5] Crown alleges these transfers of cash, notes and liability constituted "fraudulent transfers." (*See* FJ FAC ¶ 254; PWC FAC ¶ 259.) The "fraudulent transfers" rendered Crown "insolvent, [sic] in that its liabilities, including future probable liabilities, exceeded its assets. (FJ FAC ¶ 260(m); PWC FAC ¶ 265(m).)

In order to persuade the "independent" Crown directors to approve the "Spin," JRC hired defendant Houlihan Lokey, an investment banking firm, to render a "solvency opinion" to be presented to Crown. (FJ FAC ¶¶ 25, 169-70; PWC FAC ¶¶ 28, 174-75.) JRC provided Houlihan Lokey with "inflated projections" that had been created by defendant Williams, the President of JRC, who was "directly involved in each aspect of structuring and planning of the Spin," and by defendant Merrill Lynch, an underwriter serving as Crown's investment adviser and which "was primarily responsible for structuring the Spin." (FJ FAC ¶¶22, 33, 173, 205, 278, 286, 446; PWC FAC ¶¶ 25, 36, 178, 210, 283, 291, 451.) In its opinion, Houlihan Lokey "rubber-stamp[ed]" JRC's projections, although Houlihan Lokey knew it could not justifiably rely on the projections, and advised the Crown directors that Crown "would go forward as a solvent business." (FJ FAC ¶¶ 204, 207, 437; PWC FAC ¶¶209, 212, 442.)

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[5] Many of the transferred liabilities were not associated with any of the transferred assets. (FJ FAC ¶ 159(b); PWC FAC ¶ 164(b).)

Williams concealed from Crown the fact that the value of the assets JRC transferred to Crown was "substantially overstated on financial statements," that the transferred liabilities were "severely understated," and that "Crown was insolvent." (FJ FAC ¶ 449; PWC FAC ¶ 454.) Just prior to the Spin, defendant PWC, an accounting firm, prepared an audit report for the Crown directors containing falsehoods by the persons who prepared Crown's financial statements; PWC "turned a blind eye to the material misrepresentations." (FJ FAC ¶¶ 19, 245-47, 455, 463-64; PWC FAC ¶¶ 22, 250-52, 460, 468-69.) Had PWC prepared a proper accounting, "Crown would have been deemed insolvent from the date of the spin." (FJ FAC ¶ 464; PWC FAC ¶ 469.) Defendant McGuire Woods, who provided legal advice to Crown with respect to the Spin, failed to advise Crown that McGuire Woods knew Crown would not have adequate capital to survive if Crown approved the Spin. (FJ FAC ¶ 213; PWC FAC ¶ 218.) Defendant Salomon, an underwriter, prepared a prospectus containing false information provided by JRC concerning the assets to be transferred by JRC to Crown, and failed to advise Crown of the falsehoods. (FJ FAC ¶¶ 23, 309, 318; PWC FAC ¶¶ 26, 314, 323.)

*3 Defendants Cutchins and Hare were Crown directors just prior to the Spin. (FJ FAC ¶¶ 398, 403; PWC FAC ¶¶ 403, 408.) During such time as Cutchins and Hare served as Crown directors, they worked to "construe all arrangements between JRC and Crown in favor of JRC," and hired Merrill Lynch to work for Crown because they knew Merrill Lynch would "go along with JRC's inflated valuation" of the assets that were to be transferred in the Spin. (FJ FAC ¶¶ 400, 402; PWC FAC ¶¶ 405, 407.) Defendants Daniel and Piemont, two of Crown's directors, both of whom were also directors of JRC,

approved the Spin even though they knew at the time that the assets transferred from JRC to Crown were "overvalued," knew that Crown was "insolvent," and knew that "the Spin was structured to only benefit JRC." (FJ FAC ¶¶ 412, 439, 442; PWC FAC ¶¶ 417, 442, 447.) Defendant Leopold, chosen by Williams to be Chairman of the Crown Board of Directors, knew "at the time of the Spin" that the assets transferred from JRC to Crown were "significantly overvalued and insufficient collateral to the subordinated debt offering." (FJ FAC ¶ 419, 421, 423; PWC FAC ¶¶ 424, 426, 428.) Defendant Showalter, a Crown director who had been an employee of JRC, knew the "true condition" of assets transferred from JRC to Crown and worked closely with PWC to "hide the fact that Crown's assets were overvalued." (FJ FAC ¶ 434-35; PWC FAC ¶¶ 439-40.)

After the transfers, JRC distributed "all of the outstanding shares of Crown Vantage to the JRC shareholders." (FJ FAC ¶ 257; PWC FAC ¶ 262, 265(o).)[6] JRC continued to "exercise[ ] adverse dominion and control" over the Crown directors, and the "vestiges of JRC's control of Crown continued through and up to the time Crown filed for bankruptcy." (FJ FAC ¶¶ 346, 389; PWC FAC ¶¶ 351, 394.) JRC, assisted by the other defendants, "continued to misrepresent and/or conceal Crown's true financial condition ... long after Crown became insolvent." (FJ FAC ¶ 389; PWC FAC ¶ 394.) The

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[6] Although the FACs do not state on what date this occurred, Crown reported to the SEC in 1997 in a Form 10-K that "[a] total of 8,446,362 shares of [Crown Vantage]'s common stock were issued and began trading on NASDAQ on August 28, 1995." (*See* Hibbard Decl. Ex. G at 4.) Defendants' request, unopposed by Crown, that the Court take judicial notice of the Form 10-K is hereby GRANTED.

"concealment of Crown's true financial condition artificially prolonged the life of Crown while giving the illusion ... that Crown's business was prosperous when, in fact, it was not." (FJ FAC ¶ 393; PWC FAC ¶ 398.)

McGuire Woods, who continued to represent Crown, concealed from Crown after the Spin "all documents and information related to the Spin." (FJ FAC ¶ 350; PWC FAC ¶ 355.) Merrill Lynch and Houlihan Lokey, after the transfers, provided "false and misleading opinions" that the Spin had been "fair and equitable and not a fraudulent transfer." (FJ FAC ¶ 351; PWC FAC ¶ 356.) PWC prepared and disseminated "false and misleading financial statements" to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life." (FJ FAC ¶ 489; PWC FAC ¶ 494.) Salomon, who "conducted due diligence regarding Crown's post-Spin operations," did not advise Crown of "the true nature of the assets." (FJ FAC ¶¶ 357-58; PWC FAC ¶¶ 362-63.) Defendant Credit Suisse First Boston Corporation's predecessor, DLJ, which beginning in 1997 worked for Crown as a financial advisor pursuant to the terms of an "engagement letter," did not advise Crown of the true value of its assets and should have advised Crown to file for bankruptcy, rather than to continue as a "going concern." (FJ FAC ¶¶ 360, 379-80; PWC FAC ¶¶ 365, 384-85.)

*4 Defendant E & Y, an accounting firm that began performing services for Crown after the Spin, prepared audits for Crown that falsely represented Crown's financial position. (FJ FAC ¶¶ 20, 538; PWC FAC ¶¶ 23, 543.) In particular, E & Y "intended to hide the fact" that other defendants had "failed to properly write-down" the value of certain assets. (FJ FAC ¶ 608; PWC

FAC ¶ 612.) Showalter worked with E & Y to approve each of E & Y's audits of Crown so as "to conceal Crown's deepening insolvency, to hide the over-valuing of the transferred assts and to conceal his wrongdoing and that of [the other] Defendants." (FJ FAC ¶ 436; PWC FAC ¶ 441.) Williams, Cutchins, Hare, and Leopold also were aware of, but failed to disclose, Crown's insolvency after the Spin. (FJ FAC ¶¶ 341-42; PWC FAC ¶¶ 346-47.) Daniel and Piemont, after the Spin, failed to take any step to "remedy the Spin." (FJ FAC ¶ 443; PWC FAC ¶ 448.)

On March 18, 1998, JRC and Crown entered into a settlement agreement, under which Crown's obligations to JRC under the PIK Notes were modified and Crown released any "potential claims arising out of the Spin" that Crown had against JRC and certain "generically described parties." (FJ FAC ¶¶ 323-24, 333; PWC FAC ¶¶ 328-29, 338.) Crown alleges that the release was a "fraudulent conveyance" because "Crown received nothing in return for the release of claims." (*See* FJ FAC ¶ 335; PWC FAC ¶ 340.)

Showalter, in his capacity as a Crown director but acting in the best interest of JRC, voted to approve the settlement agreement. (FJ FAC ¶ 438; PWC FAC ¶ 443.) Piemont and Daniel voted to approve the settlement agreement even though it provided no benefit to Crown. (FJ FAC ¶ 443; PWC FAC ¶ 448.) Leopold signed the settlement agreement on behalf of Crown, thereby "potentially absolv[ing] JRC of any liability for certain prior wrongful acts done to Crown," even though Leopold had, four months earlier, stated to JRC that one of the Spin transactions had been "a one-sided deal, drafted only in favor of JRC." (FJ FAC ¶¶ 431-32; PWC FAC ¶¶ 436-

37.) E & Y, knowing there was "no economic justification" for the settlement agreement, failed to disclose that the settlement agreement was "absent arms length fairness or proper consideration." (FJ FAC ¶¶ 517-18; PWC FAC ¶¶ 522-23.) DLJ advised Crown to enter into the settlement agreement in order to "protect" JRC and other defendants from liability as a result of the Spin. (FJ FAC ¶¶ 386-87; PWC FAC ¶¶ 391-92.)

On March 15, 2000, Crown, having "become insolvent by well in excess of $1 Billion," filed for bankruptcy protection. (FJ FAC ¶ 13.)

PROCEDURAL BACKGROUND

As noted, on March 15, 2000, Crown filed for bankruptcy protection. During the course of the bankruptcy proceedings, Fort James filed proofs of claims against the bankruptcy estate. (*See* Coyne Decl., filed November 1, 2002, Exs. C-1.) On April 13, 2001, Fort James filed in the bankruptcy court the Fort James case, by which Fort James seeks, *inter alia*, a declaration that the "Transaction"[7] was not a "fraudulent transfer" and that any claim by Crown against Fort James arising out of the "Transaction" has been "waived, barred and precluded by, among other things, the doctrines of waiver, unclean hands, laches, estoppel, and any and all statutes of limitations." (*See* Compl. For Declaratory J., prayer for relief.)

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[7] The [sic] Transaction" to which Fort James refers in the Fort James case is the "Spin," or at least some of the transfers Crown alleges constituted the "Spin."

*5 On September 26, 2001, Crown filed in the bankruptcy court the Crown Vantage case, by which Crown asserts against Fort James claims for fraudulent transfer, breach of fiduciary trust, and related causes of action. By order filed November 19, 2001, the bankruptcy court, upon stipulation of the parties, deemed the Fort James case to be a counter-claim to the Crown Vantage case. On April 23, 2002, in light of Crown's jury demand in the Crown Vantage case and Fort James' lack of consent to a jury trial before the bankruptcy court, the bankruptcy court certified the Crown Vantage and Fort James cases for withdrawal of the reference.

Meanwhile, on November 19, 2001, the bankruptcy court confirmed Crown's proposed plan. Under the confirmed plan, Crown Paper Liquidating Trust ("the Liquidating Trust") became the successor-in-interest to Crown. On March 14, 2002, the Liquidating Trust filed in state court the Liquidating Trust case, alleging therein that 15 defendants participating in Fort James's wrongful conduct, aided and abetted Fort James and each other, or otherwise breached independent duties owed to Crown with respect to the "Spin" and its aftermath. E & Y removed the Liquidating Trust case to bankruptcy court. On August 8, 2002, in light of Crown's jury demand in the Liquidating Trust case and E & Y's lack of consent to a jury trial before the bankruptcy court, the bankruptcy court certified the Liquidating Trust case to the District Court for withdrawal of the reference.

On September 20, 2002, the Honorable William H. Alsup, to whom the matters were then assigned, consolidated the Crown Vantage case, the Fort James case, and the Liquidating Trust case for all pre-trial

purposes. On October 31, 2002, plaintiffs filed FACs in both the Crown Vantage and Liquidating Trust cases.

DISCUSSION

Defendants argues that Crown's claims in the FACs should be dismissed on numerous grounds. The Court will first address the arguments made by defendants in the Omnibus Memorandum of Points and Authorities in Support of Motions to Dismiss ("Omnibus Memorandum"), to which all defendants in the Liquidating Trust case and Fort James, the only defendant in the Crown Vantage case, have joined. The Court will then consider additional arguments made in the separately filed motions to dismiss.

A. Omnibus Memorandum Issues

1. Standing

As a threshold issue, defendants argue that Crown lacks standing to assert the claims made against them.[8] Defendants observe that the pleadings contain many allegations that defendants, or some of them, have misled Crown's creditors, (*see, e.g.*, PWC FAC ¶ 159 (alleging Merrill Lynch was aware statements made by certain defendants to "potential creditors" of Crown were false)), and argue that Crown is attempting to seek relief for injuries to the creditors.

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[8] Fort James has joined in this argument to the extent that Crown has asserted claims on behalf of Crown itself, specifically Counts 3 through 13 asserted in the Crown Vantage case, as opposed to the two claims brought on behalf of Crown's creditors, specifically Counts 1 and 2 asserted in the Crown Vantage case. (*See* Fort James' Official Response to Court's Question Re Joinder, filed September 9, 2003.)

The claims that Crown asserts against defendants arise from the following allegations: (1) defendants were responsible for the alleged "fraudulent transfers" occurring during the Spin, whereby, *inter alia*, Crown paid over $550,000,000 to JRC, as well as other consideration, in exchange for worthless assets; (2) defendants were aware at all times prior to Crown's filing for bankruptcy that Crown was insolvent, but failed to advise Crown of that fact and took steps to artificially prolong Crown's existence; and (3) defendants caused Crown to enter into an agreement releasing claims Crown had against JRC and others arising out of the Spin, as well as modifying other obligations Crown had to JRC, but failed to advise Crown that Crown was not receiving any valid consideration in return from JRC. Such allegations adequately allege that defendants caused injury to Crown. Consequently, Crown has standing to allege claims based on such conduct. *See National Organization for Women v. Scheidler*, 510 U.S. 249, 256, 114 S. Ct. 798, 127 L. Ed. 2d 99 (1994) (holding to establish standing, plaintiff, at pleading stage, need only allege some injury to itself "fairly traceable to the defendant's allegedly unlawful conduct").

***6** Accordingly, defendants are not entitled to dismissal on the ground that Crown has not alleged the requisite injury to itself for purposes of standing.

2. In Pari Delicto

Defendants argue that Crown is barred from asserting the claims made against them under the doctrine of in pari delicto.[9] The doctrine of in pari delicto bars a participant in an unlawful act from recovering damages from another participant in the unlawful act. *See, e.g., Terlecky v. Hurd (In re Dublin Sec., Inc.)*, 133 F.3d 377, 380 (6th Cir.1998). Where a plaintiff is a corporation, the doctrine applies if, under agency principles, the unlawful actions of an agent of the corporation are imputed to the corporation. *See id.*

a. Invoking In Pari Delicto Against Bankruptcy Trustee

Crown argues that the doctrine of in pari delicto cannot be invoked against a bankruptcy trustee, irrespective of whether it could have been invoked against the debtor corporation. Although the Ninth Circuit has not had occasion to directly address the issue, every Circuit to have considered the question has held that in pari delicto can be asserted against a trustee bringing a claim on behalf of a debtor in bankruptcy. *See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356-58* (3rd Cir.2001); *Terlecky*, 133 F.3d 377, 381 (6th Cir. 1998); *Sender v. Buchanan (In re Hedged-Investments Associates, Inc.)*, 84 F.3d 1281, 1284-86 (10th Cir. 1996); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d

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[9] Fort James has joined in this argument to the extent that Crown has asserted claims on behalf of Crown itself, specifically Counts 3 through 13 asserted in the Crown Vantage case, as opposed to the two claims brought on behalf of Crown's creditors, specifically Counts 1 and 2 asserted in the Crown Vantage case. (*See* Fort James' Official Response to Court's Question Re Joinder, filed September 9, 2003.)

1085, 1093 (2nd Cir. 1995). As explained in *Sender*, when a trustee asserts a claim on behalf of a debtor, the trustee proceeds under 11 U.S.C. § 541(a)(1), which defines the property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case." *See Sender*, 84 F.3d at 1285 (citing 11 U.S.C. § 541(a)(1)). *Sender* concluded that § 541(a)(1) "establishes the estate's rights as no stronger than they were when actually held by the debtor," and thus in pari delicto, or any other defense available as against the debtor, can be asserted against the trustee. *See id.*

The legislative history of § 541 lends support for this conclusion:

> Though this paragraph [§ 541(a)(1)] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to pursue that claim, because he too would be barred.

See H.R. Rep. 95-595, at 367-68, reprinted in 1978 U.S.C.C.A.N. 5963, 6323.

Relying on *Federal Deposit Ins. Corp. v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995), Crown argues that a different result should pertain in the Ninth Circuit. In *O'Melveny*, the Ninth Circuit, applying California law, held that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that

party's receiver." *See Id.* At 19. As the Third Circuit observed in *Lafferty*, however, *O'Melveny* is distinguishable, as that case involved a receiver, a party not subject to the restrictions of § 541(a)(1). *See Lafferty*, 267 F.3d at 358 (distinguishing *O'Melveny* from action brought by bankruptcy trustee; noting "unlike bankruptcy trustees, receivers are not subject to the limits of section 541"). Where, as here, a bankruptcy trustee files claims on behalf of the bankruptcy estate, § 541(a)(1), as discussed above, provides that the trustee's rights are no greater than the rights of the debtor. Indeed, even before the enactment of § 541(a)(1),[10] the Ninth Circuit had observed, "It is elemental that the trustee stands in the shoes of the bankrupt ... and can assert no greater rights against the [defendant] than could have been asserted by the bankrupt in the absence of bankruptcy proceedings." *See Schultz v. England*, 106 F.2d 764, 768 (9th Cir. 1939) (holding resolution of trustee's claim to equipment in building leased by landlord to debtor was dependent on whether debtor had right to possess equipment as against landlord); *see also Pellerin v. Stuhley (In re Destro)*, 675 F.2d 1037, 1040 (9th Cir. 1982) (holding, in context of adversary proceeding against debtor, that bankruptcy trustee "succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition").

*7 Consequently, defendants may assert in pari delicto as a defense.

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[10] Section 541 was enacted in November 1978.

b. Application of In Pari Delicto Defense

Because defendants raise the defense of in pari delicto on a motion to dismiss, defendants are entitled to dismissal only if the defense is established on the face of the complaints, specifically, the FJ FAC and the PWC FAC. *See, e.g., Official Committee of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.2d 147, 163-166 (2nd Cir. 2003) (affirming dismissal of claims filed on behalf of debtor where applicability of defense of in pari delicto was established in complaint). Because Crown's claims arise under state law, the issue of whether Crown's claims are barred by in pari delicto is governed by state law. *See id.* (holding where Texas law applied to state law claims filed on behalf of debtor, dismissal was appropriate where, under Texas law, defense of in pari delicto was established on face of complaint).

Here, all defendants, with the exception of E & Y and DLJ as discussed below, argue that Virginia law applies to the claims asserted against them. In large part, these defendants rely on the bankruptcy court's ruling in the Crown Vantage case that Virginia law applies to Crown's claims against Fort James. (*See* Order, filed April 23, 2002, in Crown Vantage case).[11] In its opposition, Crown has not requested reconsideration of this ruling, and, indeed, cites Virginia law as supportive of Crown's argument that Crown has stated valid claims. (*See, e.g.*,

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[11] The bankruptcy court reached this result after applying the tests set forth in the Restatement (Second) of Conflict of Laws. (See id. At 4-7.)

Pls.' Consolidated Response to Defs.' Mots. To Dismiss at 56:6-9, 68:22-7.) Consequently, the Court will apply Virginia law to Crown's claims against defendants Fort James, PWC, McGuire Woods, Merrill Lynch, Salomon, DLJ, Leopold, Cutchins, Hare, Williams, Daniel, Peimont, Showalter, and, with one exception discussed *infra*, Houlihan Lokey.

As discussed in more detail below, E & Y argues that the claims against it are governed by California law and DLJ argues that the claims against it are governed by New York law. For the purposes of the doctrine of in pari delicto, however, no party argues that the law of the three potentially relevant states, namely Virginia, California, and New York, differs in any respect with regard to the doctrine of in pari delicto. Rather, the parties agree that the analysis of the applicability of that doctrine proceeds in three specific steps.[12] First, for the doctrine to apply, agents of the plaintiff corporation must have participated in the wrongdoing for which the corporation seeks to recover. *See Mediators, [sic] Inc. v. Manney (In re Mediators)*, 105 F.3d 822, 826-27 (2nd Cir. 1997) (holding where agents of corporation participated in fraudulent scheme with defendant, corporation was barred from asserting claim against defendant, unless exception to doctrine of in pari delicto applied).[13] Second, if such

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[12] No party cites any case applying either Virginia or California law in which the doctrine of in pari delicto was applied in a case similar to the instant action. No party, however, argues that Virginia or California would apply the doctrine in a manner different from that set forth in the decisions from other jurisdictions on which all parties have relied.

[13] Although the Second Circuit in *Mediators* did not specifically identify the applicable doctrine, a later decision of the Second Circuit

agents, at the time of such participation, were acting in a manner adverse to the interests of the corporation, the so-called "adverse interest exception" applies, with the result that the actions of the agents are not imputed tot the corporation. *See, e.g., Bankruptcy Services, Inc. v. Ernst & Young (In re CBI Holding Co.)*, 247 B.R. 341, 365 (Bankr. S.D.N.Y.2000) (holding where "segment of management involved in the fraud was acting for its own interest and not that of [the corporation]," their participation in accounting fraud was not imputed to corporation, and corporation's claim against defendant accounting firm was not barred). Third, even if the agents of the corporation were acting in a manner adverse to the interests of the corporation, where the agents and the corporation are "one and the same," the "sole actor exception" applies to the "adverse interest exception," with the result that in pari delicto will bar the claim. *See, e.g., Lafferty, 267 F.3d at 359* (holding "sole actor exception" applied to bar corporation from suing its underwriters for participating with agents of corporation in fraudulent scheme, where such agents "clearly dominated" corporation and one of the agents was the "sole shareholder" of corporation).

***8** Here, according to the FACs, the majority of Crown's directors, along with JRC, participated in all of the allegedly wrongful acts. As discussed above, those acts are alleged to have caused injury to Crown, thus bringing

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clarified that the doctrine in question was in pari delicto. *See Coopers & Lybrand*, 322 F.3d at 164 (describing *Mediators* as case where Second Circuit affirmed dismissal "upon findings that in pari [sic] delicto had been established in the complaints").

into play the "adverse interest exception."[14] As a consequence, unless the applicability of the "sole actor exception" is apparent from the face of the complaints, defendants are not entitled to dismissal based on the doctrine of in pari delicto.

Defendants argue that the sole actor exception applies in light of Crown's allegation that "JRC, as the sole shareholder of Crown Vantage, exercised dominion and control over Crown as to the Spin," (*see* FJ FAC ¶ 260(a); PWC FAC ¶ 265(a)), and that JRC had "sole and complete decision-making" during those transactions. (*See* FJ FAC ¶ 134; PWC FAC ¶ 139.) In support of this argument, defendants rely on cases applying the sole actor exception where the sole shareholder of the plaintiff corporation participated in the alleged wrongdoing. *See, e.g., Mediators*, 105 F.3d at 827 (holding where sole shareholder "is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply"; barring corporation's claim against bank and law firm for allegedly assisting shareholder in stripping corporation of its assets). In explaining the basis for this result, the Second Circuit has stated: "This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because

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[14] Defendants, relying on Crown's allegation that some defendants defrauded banks into loaning Crown large sums of money, argue that JRC and certain of the other defendants in fact provided benefits to Crown. (*See* Defs.' Omnibus Reply at 13.) As noted above, however, Crown also alleges that after Crown received those funds, the Crown directors voted to transfer the funds to JRC in exchange for JRC's worthless assets. When viewed in the light most favorable to Crown, these allegations cannot be read as a concession that JRC or any other defendant acted for the benefit of Crown.

the party that should have been informed was the agent itself albeit in its capacity as principal. Where, as here, a sole shareholder is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply." *See id.*

In response, Crown relies on its allegations that Crown had "independent" directors who did not participate in, and were unaware of, the wrongdoing, (*see, e.g.*, FJ FAC ¶¶ 167-69; PWC FAC ¶¶ 172-74), as well as its allegations that the independent directors "could have taken steps to prevent the damages and losses [Crown] incurred as a result of the wrongful conduct" had they known of the conduct. (*See* FJ FAC ¶ 346; PWC FAC ¶ 351.) Crown cites several cases holding that the doctrine of in pari delicto does not apply where independent directors could have prevented or stopped the wrongful conduct had they been made aware of it. *See, e.g., Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 278 B.R. 28, 37-39 (Bankr.E.D.N.Y.2002) (holding plaintiff's allegation that "innocent" director would have had ability to "bring an end to the fraudulent activity" was sufficient to withstand motion to dismiss based on in pari delicto); *Smith v. Arthur Andersen L.L.P.*, 175 F. Supp. 2d 1180, 1198-1200 (D.Ariz.2001) (holding plaintiff's allegation that there were "innocent members on [plaintiff's] Board and Audit Committee who were unaware of the wrongdoing" was sufficient to withstand motion to dismiss based on in pari delicto); *CBI Holding*, 247 B.R. at 365 (holding evidence that one of plaintiff's directors "had he known of the fraud, would have taken steps to stop it" was sufficient to defeat defendant's argument that fraud committed by certain of plaintiff's officers and managers as imputed to plaintiff); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld,*

L.L.P., 212 B.R. 34, 45-46 (S.D.N.Y. 1997) (dismissing complaint with leave to amend to allege "innocent member" of plaintiff's management would have had ability to stop CEO's fraudulent activity had such person known of it). In none of the cases on which Crown relies, however, was the plaintiff a corporation owned by a sole shareholder who participated in the wrongdoing for which the plaintiff sought relief. *See, e.g., Sharp*, 278 B.R. at 37-39 (observing corporation had "innocent 13% shareholder" at all times); *Smith*, 175 F. Supp. 2d at 1187, 1199 (noting plaintiff corporation argued that sole actor exception did not apply because case did not involve allegation that sole shareholder engaged in wrongdoing; observing corporation had alleged defendants, former officers and directors, had concealed material information from corporation's shareholders); *CBI Holding*, 247 B.R. at 365 (observing plaintiff's 48% shareholder "was innocent of the fraud"); *Wechsler*, 212 B.R. at 35 (observing alleged wrongdoers were not sole shareholders of plaintiff).

***9** Although Crown argues that the sole actor exception is inapplicable unless all shareholders and directors participate in the fraud, Crown cites no case in which the sole actor exception was held inapplicable where a sole shareholder participated in the fraud. Rather, irrespective of whether all or some of the directors also participated, the courts have held that where a sole shareholder is a participant in the wrongdoing, an allegation that independent or innocent directors could have taken steps to stop the wrongful conduct is insufficient to avoid the bar of in pari delicto. *See, e.g., Lafferty*, 267 F.3d at 360 (affirming dismissal based on in pari delicto where sole shareholder participated in alleged wrongful conduct for which plaintiff sought relief; holding plaintiff's allegation

that some directors did not perpetrate fraud insufficient to avoid application of in pari delicto); *FDIC v. Ernst & Young*, 967 F.2d 166, 171-72 and n. 2 (5th Cir. 1992) (affirming grant of summary judgment against plaintiff corporation where "sole owner" of corporation engaged in accounting fraud and "dominated the board of directors"; holding evidence that "three outside directors" would have acted differently had they known of fraud insufficient to create triable issue of fact). Under the law of Virginia, the state in which Crown was incorporated, such a result follows from the fact that a sole shareholder has the right to remove directors. *See* Va. Code Ann. § 13.1-680 (affording shareholders right to remove directors). Consequently, to the extent Crown's claims are based on conduct occurring while JRC was Crown's sole shareholder, Crown's "independent" director allegations do not assist Crown in avoiding dismissal based on in pari delicto.

Relying on principles of comparative fault as recognized in California and New York, Crown argues that even if the bar of in pari delicto is apparent from the face of the complaints, the Court, at the pleading stage, should not determine that the bar is complete as to any claims governed by the law of those states, because a jury might conclude that defendants' wrongdoing exceeded that of Crown. None of the claims as to which in pari delicto is applicable, however, is governed by the law of any state other than Virginia.[15] Under Virginia law, negligence on

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[15] The parties agree that the claims based on conduct occurring while JRC was Crown's sole shareholder are subject to Virginia law. The agreement on which DLJ relies in support of its argument that New York law applies was not executed until 1997, well after Crown's stock became available to the public. All of the claims against

the part of a plaintiff, if concurrent with that of a defendant, is a complete bar to any recovery on a negligence claim. *See Ponirakis v. Choi*, 262 Va. 119, 546 S.E.2d 707, 711 (Va. 2001). Although, "[g]enerally, an issue whether a plaintiff is guilty of contributory negligence is a question of fact to be decided by the trier of fact," *see id.*, here, as discussed above, the alleged wrongful acts of JRC, when it was Crown's sole shareholder, are imputed as a matter of law to Crown as a result of the applicability of the doctrine of in pari [sic] delicto. In other words, there is no triable issue of material fact with respect to contributory negligence.

***10** Accordingly, defendants are entitled to dismissal of Crown's claims to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder. Because Crown has alleged that all of the transactions comprising the Spin occurred while JRC was Crown's sole shareholder, (*see, e.g.*, PWC FAC ¶ 265(a)), Crown's claims based on such transactions are barred by the doctrine of in pari delicto.[16] In light of Crown's allegations that JRC was not Crown's sole shareholder after the completion of the transactions that

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E & Y, who argues California law governs the claims against it, arise from conduct occurring after Crown's stock became available to the public.

[16] In the Omnibus Memorandum, defendants also argue that Crown's claims based on the transactions comprising the Spin are subject to dismissal on the grounds that Crown has failed to adequately allege the element of causation, has failed to adequately allege a basis for finding defendants owed Crown fiduciary duties with respect to such transactions, and has pleaded facts establishing the bar of the statute of limitations. In light of the Court's finding with respect to the doctrine of in pari delicto, the Court need not decide these issues.

comprised the Spin, however, and the allegations that the independent board members could have taken steps to remedy the alleged wrongdoing by defendants, defendants are not entitled to dismissal of Crown's claims to the extent the claims are based on conduct occurring after JRC was no longer Crown's sole shareholder.

3. Aiding and Abetting Fraudulent Transfers

Crown alleges that defendants in the Liquidating Trust case, with the exception of E & Y, are liable for aiding and abetting fraudulent transfers of assets from Crown to Fort James.[17] (*See* PWC FAC ¶¶ 329, 333-340 (alleging Fort James was sole transferee of certain property of Crown); PWC FAC Counts 2, 12, 23, 40, 45, 50, 58, 63, 68, 73, 78, 83.) Defendants argue that such claims are subject to dismissal because no such claim is cognizable under bankruptcy law, Virginia law, or New York law.

Under bankruptcy law pertaining to recovery for a fraudulent conveyance, "recovery may be had only against persons who have received the property in question." *See Elliott v. Glushon*, 390 F.2d 514, 514, 517 (9th Cir. 1967) (holding trustee seeking relief from fraudulent conveyance may only recover from transferee; affirming dismissal of claim for damages against attorney who allegedly

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[17] As a result of the Court's dismissal of certain claims based on in pari delicto, the Court has dismissed any claim based on the theory that defendants in the Liquidating Trust case aided and abetted JRC in effectuating the transactions comprising the Spin. Consequently, the Court will address the propriety of Crown's aiding and abetting fraudulent transfer claims only to the extent such claims are based on Crown's 1998 settlement agreement with Fort James, which agreement Crown also alleges to be a fraudulent conveyance.

conspired with debtor to fraudulently convey estate's property to third party). Likewise, under Virginia law, a plaintiff seeking recovery for a fraudulent conveyance may only seek recovery of the property, or under limited circumstances the value of the property, from the transferee. *See Efessiou v. Efessiou*, 41 Va. Cir. 142, 1996 WL 1065637, *4 (1996) (citing Supreme Court of Virginia decisions so holding). Similarly, under New York law, a plaintiff who seeks recovery for a fraudulent conveyance may "obtain a nullification of the conveyance" and/or "secure the assets in satisfaction of the debt," remedies which by definition are available only from the transferee. *See FDIC v. Porco*, 75 N.Y.2d 840, 552 N.Y.S.2d 910, 552 N.E.2d 158, 159 (N.Y.1990)(holding trial court erred by not dismissing claim for damages based on allegation defendants "assisted" debtor in transferring debtor's assets outside of country; reaffirming "traditional rule in this State reject[ing] any cause of action for mere participation in the transfer of a debtor's property prior to the creditor's obtaining a judgment"). Consequently, Crown cannot state a claim for relief under either bankruptcy law, Virginia law, or New York law for aiding and abetting fraudulent transfers.

***11** Crown argues that, in the event its claims for aiding and abetting a fraudulent transfer are not cognizable, such claims should be construed as claims for aiding and abetting a breach of fiduciary duty or for common law conspiracy to commit a fraudulent act. Crown, however, has alleged claims for aiding and abetting breach of fiduciary duty against each defendant against whom it has alleged a claim for aiding and abetting fraudulent transfers. Further, neither Virginia nor New York recognizes a claim for conspiracy to effect a fraudulent

conveyance. *See Efessiou*, 41 Va. Cir. 142, 1996 WL 1065637, *4-5 (dismissing claim for conspiracy to effect fraudulent conveyance because, under Virginia law, "there can be no civil action for conspiracy where the unlawful act underlying the conspiracy claim does not allow for a damage award," and Virginia does not permit damage award as remedy for fraudulent conveyance); *Porco*, 552 N.Y.S.2d 910, 552 N.E.2d at 159 ("Nor is there merit to plaintiff's argument that [a New York statute] creates a creditor's cause of action in conspiracy, assertable against nontransferees or nonbeneficiaries solely for assisting in the conveyance of a debtor's assets.")

Accordingly, Crown's claims for aiding and abetting fraudulent transfers, specifically Counts 2, 12, 23, 40, 45, 50, 58, 63, 68, 73, 78, 83 in the Liquidating Trust case, are subject to dismissal, without leave to amend.

4. Negligent Misrepresentation Claims

Crown alleges claims for negligent misrepresentation against some of the defendants. Fort James, Houlihan Lokey, McGuire Woods, PWC, Merrill Lynch, and Salomon argue that the claims for negligent misrepresentation asserted against them are governed by Virginia law,[18] and that such claims are not cognizable because Virginia law does not recognize a tort of negligent misrepresentation. *See Bentley v. Legent Corp.*,

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[18] Crown also alleges claims for negligent misrepresentation against E & Y and DLJ. These claims arise from conduct allegedly occurring after JRC was no longer Crown's sole shareholder. The parties to such claims agree that the law of states other than Virginia governs such claims.

849 F. Supp. 429, 434 (E.D.Va.1994) ("Virginia does not recognize any tort of negligent misrepresentation.") In response, Crown does not offer any contrary authority recognizing such claims under Virginia law. Consequently, the negligent misrepresentation claims asserted under Virginia law are subject to dismissal.

Houlihan Lokey, however, has not shown that Crown's claim for negligent misrepresentation against it is subject to Virginia law. To the extent that claim is not subject to dismissal pursuant to the doctrine of in pari delicto, the claim for negligent misrepresentation against Houlihan Lokey appears to be based solely on alleged statements made by Houlihan Lokey in an opinion letter to Crown dated July 8, 1999. (*See* PWC FAC ¶ 360.) Crown alleges that such opinion letter was issued as a result of a June 1, 1999 agreement, which, Crown states, the parties agreed would be governed by California law. (*See* PWC FAC ¶¶ 360-61.)[19] Under California law, a claim for negligent misrepresentation is cognizable. *See Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 408, 11 Cal. Rptr. 2d 51, 834 P.2d 745 (1992) ("Where the defendant makes false statements, honestly believing that they are true, but without reasonable ground for such belief, he may be liable for negligent misrepresentation, a form of deceit.") Consequently, given the potential for application of California law to Crown's claim for negligent misrepresentation as based on the opinion letter, Houlihan

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[19] Both Houlihan Lokey and Crown only address Crown's allegation that Houlihan Lokey made misrepresentations during the time JRC was Crown's sole shareholder. Consequently, neither party has addressed the effect of the choice of law provision allegedly included in the parties' June 1999 agreement.

Lokey has not shown that such claim is subject to dismissal.

*12 Crown argues that, as to those defendants subject to Virginia law, its claims for negligent misrepresentation should be construed as claims for constructive fraud. In support thereof, Crown cites *Hitachi Credit America Corp. v. Signet Bank*, 166 F.3d 614 (4th Cir. 1999), in which the Fourth Circuit observed that a claim for constructive fraud under Virginia law can be based on a false statement that is made negligently: "Constructive fraud differs [from actual fraud] only in that the misrepresentation of fact is not made with the intent to mislead, but is made innocently or negligently; the plaintiff must still prove the other elements of actual fraud--reliance and detriment--by clear and convincing evidence." *See id.* at 628. Crown, however, has separately alleged constructive fraud claims against McGuire Woods and PWC and, consequently, leave to amend to allege constructive fraud against those defendants is unnecessary.

Accordingly, Crown's claims titled "negligent misrepresentation" against Fort James (Count 7 in the Crown Vantage case), McGuire Woods (Count 7 in the Liquidating Trust case), PWC (Count 18 in the Liquidating Trust case), Merrill Lynch (Count 39 in the Liquidating Trust case), and Salomon (Count 44 in the Liquidating Trust case), are subject to dismissal for failure to state a claim under Virginia law. Crown will, however, be afforded leave to amend to allege claims for constructive fraud against Fort James, Merrill Lynch and Salomon, to the extent Crown bases such claims on conduct occurring after Fort James no longer was Crown's sole shareholder.

5. Breach of the Duty of Good Faith and Fair Dealing Claims

Crown alleges claims for tortuous breach of the duty of good faith and fair dealing against defendants Fort James, McGuire Woods, PWC, E & Y, and DLJ. Defendants argue that such claims are not cognizable.

Virginia law governs the claims against Fort James, McGuire Woods and PWC. Virginia does not recognize a cause of action for tortuous breach of the duty of good faith and fair dealing. *See Charles E. Brauer Co. v. Nationsbank*, 251 Va. 28, 466 S.E.2d 382, 385 (Va.1996) (holding breach of implied covenant of good faith and fair dealing does not constitute a tort, but gives rise only to a claim for breach of contract.) New York law governs the claim against DLJ.[20] New York does not recognize a cause of action for tortious breach of the duty of good faith and fair dealing. *See Harris v. Provident Life Accident Ins. Co.*, 310 F.3d 73, 80 (2nd Cir. 2002) ("Under New York law, parties to an express contract are bound by an implied duty of good faith, but breach of that duty is merely a breach of the underlying agreement.") California law governs the claim against E & Y.[21]

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[20] DLJ argues that all of the claims asserted against it are governed by New York law. At the hearing conducted August 15, 2003, Crown stated that it does not dispute DLJ's argument, to the extent Crown's claims are based on conduct arising out of the performance of DLJ's contractual duties.

[21] E & Y argues that all of the claims asserted against it are governed by California law. At the hearing conducted August 15, 2003, Crown stated that it does not dispute E & Y's argument, to the extent Crown's claims are based on conduct arising out of the performance of E & Y's contractual duties.

California, with limited exceptions not applicable to the instant action, does not recognize a cause of action for tortuous breach of the duty of good faith and fair dealing. *See Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal. 4th 390, 400 (2000) (holding plaintiff alleging breach of covenant of good faith and fair dealing is, outside of context of insurance contracts, "limited to contract rather than tort remedies").

***13** Crown argues that its claims for tortuous breach of the covenant should be allowed to proceed as claims for breach of fiduciary duty. Crown, however, has alleged claims for beach of fiduciary duty against Fort James, McGuire Woods, PWC, E & Y, and DLJ.

Accordingly, Crown's claims for tortuous breach of the duty of good faith and fair dealing, specifically, Count 13 in the Crown Vantage case and Counts 16, 27, 37, and 54 in the Liquidating Trust case are subject to dismissal, without leave to amend.

6. Deepening Insolvency Claims

In the Omnibus Memorandum, defendants do not specifically address Crown's claims for damages based on a "deepening insolvency" theory. (*See* PWC FAC Prayer for Relief ¶ A.) Crown bases such claims on conduct occurring after JRC was not longer Crown's sole shareholder. (*See, e.g.*, PWC FAC ¶¶ 494 (alleging PWC prepared and disseminated "false and misleading financial statements" after transactions comprising Spin had occurred in order to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life").) In their reply offered in support of the Omnibus Memorandum, defendants address

the "deepening insolvency" claims, arguing therein that such claims are not cognizable because Crown alleges it was insolvent at the time the transactions comprising the Spin were effectuated. (*See, e.g.*, PWC FAC ¶ 236 (alleging "[a]t the time of the Spin and thereafter, Crown was insolvent").) Although not clearly expressed, it appears defendants are arguing that a "deepening insolvency" claim is cognizable only where the plaintiff corporation was initially solvent and later became insolvent, after which time a defendant took action to cause the corporation's insolvency to deepen. Defendants cite no authority in support of this proposition, either as a matter of Virginia law or otherwise. For this reason, and because defendants have raised this argument for the first time in their reply, the Court will not further address the argument at this time. As the Court indicated at the hearing conducted August 15, 2003, however, the Court will not preclude defendants from filing a second motion to dismiss to specifically address Crown's claims based on conduct occurring after JRC was no longer Crown's sole shareholder.

B. Motion to Dismiss Claims in Crown Vantage Case

Fort James, in addition to relying on the arguments made in the Omnibus Memorandum, makes additional arguments in support of dismissal. With respect to the claims brought by Crown on its own behalf, Fort James has specifically addressed only Crown's claims based on conduct occurring during such time as JRC was Crown's sole shareholder. In light of the Court's ruling as to in pari delicto, the Court finds it unnecessary to address the separate arguments made by Fort James in support of dismissal of such claims.

The Court will, however, address Fort James's arguments in support of dismissal of Crown's claims brought on behalf of creditors.[22]

1. Count One

*14 Count One, brought by Crown on behalf of its creditors, alleges that the transfers of property from Crown to JRC under the "Spin" constituted fraudulent conveyances under 11 U.S.C. § 544(b).

"[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor." 11 U.S.C. § 544(b). "Applicable law" within the meaning of § 544(b) includes state law. *See Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 593 (9th Cir. 1991). Crown and Fort James agree that the "applicable law" as to Count 1 is the law of Virginia. Fort James does not argue that Crown fails to state a claim for fraudulent conveyance under Virginia law;[23] rather, Fort James argues that the claim, which it asserts accrued in August 1995 when the subject transfers occurred, is barred by a four-year statute of limitations applicable

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[22] These claims are not addressed in the Omnibus Memorandum.

[23] Under Virginia law, a transfer "given with intent to delay, hinder or defraud creditors, purchasers or other persons of or from what they are or may be lawfully entitled to shall, as to such creditors, purchasers or other persons, their representatives or assigns, be void," *see* Va. Code Ann. § 55-80, and a transfer "which is not upon consideration deemed valuable in law ... by a transferor who is thereby rendered insolvent, shall be void as to creditors whose debts shall have been contracted at the time it was made ...." *See* Va. Code Ann. § 55-81.

under California law. Crown, in opposition, argues that Virginia law as to the statute of limitations should apply.

Fort James cites no case in which a bankruptcy court applying the law of one state for purposes of assessing the merits of a fraudulent conveyance claim has applied the law of a different state for purposes of the statute of limitations. By contrast, numerous cases, when applying a given state's law as to a claim for fraudulent conveyance under § 544(b), have applied that same state's statute of limitations. *See, e.g., Dietz v. St. Edward's Catholic Church (In re Bargfrede)*, 117 F.3d 1078, 1080 (8th Cir.1997) (holding trustee's claim under § 544(b) subject to Iowa law, both as to elements of claim and statute of limitations); *Womack v. Eggebrecht (In re Demis)*, 191 B.R. 851, 856 (Bankr.D.Mont.1996) (holding where trustee sought to set aside transfer under Montana law pursuant to 544(b), "Montana law determines the limitations period"); *Mahoney, Trocki & Assocs. v. Kunzman (In re Mahoney, Trocki & Assocs.)*, 111 B.R. 914, 917 (Bankr. S.D. Cal. 1990) (holding, as to claim under § 544(b), where "California law on fraudulent conveyances is being utilized, California statute of limitations must be applied as well"; citing cases in support thereof).

Consequently, the Court will apply Virginia- law to determine the applicable statute of limitations. In that respect, as Fort James acknowledges, the Supreme Court of Virginia has held that an action to set aside a conveyance of the ground of actual fraud is not subject to any statute of limitations. *See Flook v. Armentrout's Adm'r*, 100 Va. 638, 42 S.E. 686, 687 (Va.1902) (holding no statute of limitations barred claim to set aside fraudulent conveyance "upon the ground of actual fraud";

considering merits of claim brought ten years after subject conveyance occurred).[24] Here, Crown alleges that the conveyances "were made with the actual intent to hinder, delay and defraud Crown's creditors." (*See* FJ FAC ¶ 723.)

***15** Accordingly, For James is not entitled to dismissal of Count 1 based on the statute of limitations.[25]

2. Count Two

In Count Two, also brought by Crown on behalf of its creditors, Crown alleges that the settlement agreement Crown entered into with Fort James in 1998 was a fraudulent conveyance that should be set aside under § 544(b). Crown alleges that because the settlement agreement was a fraudulent conveyance, the release therein is "ineffective to release the claims held by any creditors of Crown." (*See* FJ FAC ¶ 753.)

Fort James argues that if Count One is dismissed, Count Two is moot. Assuming, *arguendo*, Fort James' assertion

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[24] At least one bankruptcy court, sitting in Virginia, has held that such a claim is subject to the equitable doctrine of laches. *See In re Massey*, 225 B.R. 887, 891 (Bankr.E.D.Va.1998). Because Fort James does not argue that Court 1 is barred by laches, the Court need not decide whether laches is a cognizable defense to a claim for fraudulent conveyance under Virginia law.

[25] Crown alternatively argues that because it has alleged that one of the creditors is the United States, the trustee, standing in the shoes of the United States, is not bound by any state statute of limitations. In light of the Court's finding with respect to the applicability of Virginia law as to the statute of limitations, the Court need not address Crown's alternative argument.

is correct, Fort James is not entitled to dismissal of Count Two as Count One is not subject to dismissal.

C. Motion to Dismiss Claims in Liquidating Trust Case

All defendants in the Liquidating Trust case, in addition to seeking dismissal for the reasons stated in the Omnibus Memorandum, seek dismissal of the claims asserted against them for reasons set forth in their separate motions to dismiss.

The separate motions filed on behalf of defendants Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Leopold, Cutchins, Hare, Williams, Daniel, Piemont, and Showalter specifically address only Crown's claims based on conduct occurring during such time as JRC was Crown's sole shareholder.[26] In light of the Court's ruling as to in pari delicto, it is unnecessary to address the separate arguments made by these defendants.

The motions filed by PWC, E & Y and DLJ do specifically address Crown's claims based on conduct occurring after JRC was no longer Crown's sole shareholder. In the interests of judicial economy, however, the Court will defer ruling on those portions of the motions filed by PWC, E & Y and DLJ until such time as all defendants have had the opportunity to specifically address such claims.

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[26] Each defendant in the Liquidating Trust case is alleged to have participated in some type of wrongful conduct after the time JRC ceased to be Crown's sole shareholder, as well as to have aided and abetted wrongful conduct of other defendants and to have participated in a conspiracy during such time.

CONCLUSION

For the reasons discussed, defendants' motions to dismiss are GRANTED in part and DENIED in part, as follows.

1. In the Crown Vantage case,

a. Counts 3 to 12 are hereby DISMISSED without leave to amend, to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder;

b. Count 7 is hereby DISMISSED with leave to amend;[27]

c. Count 13 is hereby DISMISSED without leave to amend; and

d. in all other respects, the motion filed by Fort James is hereby DENIED.

2. In the Liquidating Trust case,

a. all claims are hereby DISMISSED without leave to amend, to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder;

b. Counts 2, 7, 12, 16, 18, 23, 27, 37, 40, 45, 50, 54, 58, 63, 68, 73, 78, 83 are hereby DISMISSED without leave to amend;

c. Counts 39 and 44 are hereby DISMISSED with leave to amend;

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[27] The Court, after addressing any motions seeking dismissal of claims based on conduct occurring after JRC was no longer Crown's sole shareholder, will provide a deadline by which Crown may amend.

d. in all other respects, the motions filed by Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Cutchins, Hare, Leopold, Showalter, Daniel, Piemont, and Williams are hereby DENIED; and

*16 e. ruling on the motions to dismiss filed by PWC, E & Y, and DLJ, to the extent such motions address conduct occurring after JRC was no longer Crown's sole shareholder, is hereby DEFERRED.

3. Fort James, Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Cutchins, Hare, Leopold, Showalter, Daniel, Piemont, and Williams may, no later than 30 days from the date of this order, file motions to dismiss, addressing claims based on conduct occurring after JRC was no longer Crown's sole shareholder. At the hearing on any such motions, the Court will also address the remaining arguments in the motions filed by PWC, E & Y, and DLJ.

This order closes Docket Numbers 83, 84, 86, 89, 90, 96, and 97.

IT IS SO ORDERED.

APPENDIX C

United States District Court,

N.D., California

In re: CROWN VANTAGE, INC., Debtor.

No. 02-3836MMC.

July 12, 2004.

ORDER GRANTING DEFENDANTS' MOTIONS TO DISMISS FIRST AMENDED COMPLAINT IN LIQUIDATING TRUST CASE; GRANTING IN PART AND DENYING IN PART MOTION TO DISMISS FIRST AMENDED COMPLAINT IN CROWN VANTAGE CASE (Docket Nos. 88, 91, 93, 208, 210, 211, 213, 216, 226, 278)

CHESNEY, J.

*1 The above-titled consolidated proceeding consists of three matters: (1) *Crown Paper Liquidating Trust v. PricewaterhouseCoopers, et al.*, C 02-3836 MMC ("the Liquidating Trust case"); (2) *Fort James Corporation v. Crown Vantage, Inc., et al.*, C 02-3838 ("the Fort James case"), and (3) *Crown Paper Co., et al., v. Fort James Corp., et al.*, C 02 3839 MMC ("the Crown Vantage case").

By order filed September 25, 2003, the Court granted in part and denied in part nine motions to dismiss filed by defendants in the Liquidating Trust case and the motion to dismiss filed by defendants in the Crown Vantage case. In its order, the Court dismissed (1) all claims in the First

Amended Complaint in the Liquidating Trust case ("the PWC FAC"), as well as 10 of the 13 counts in the First Amended Complaint in the Crown Vantage case ("The FJ FAC"), "to the extent the claims are based on conduct occurring while JRC [James River Corporation] was Crown's[1] sole shareholder," (*see* Order Granting in Part and Denying in Part Defs. Mots. To Dismiss, Deferring Ruling on Certain Issues, filed September 25, 2003, ("Order of September 25, 2003") at 27:9-11, 27:16-17); (2) dismissed 18 of the 86 counts in the PWC FAC and 1 of the 13 counts in the FJ FAC without leave to amend, (*see id.* at 27:13; 27,18-19); (3) dismissed 2 of the 86 counts in the PWC FAC and 1 of the 13 counts in the FJ FAC with leave to amend, (*see id.* at 27:12, 27:20); and (4) deferred ruling on portions of three of the motions to dismiss the PWC FAC, specifically, the portions addressing claims based on "conduct occurring after JRC was no longer Crown's sole shareholder," until such time as other defendants had the opportunity to file motions to dismiss to address claims based on "conduct occurring after JRC was no longer Crown's sole shareholder," (*see id.* at 27:24--28:7).

Now before the Court is the motion of defendants Fort James Corporation, Fort James Operating Company, Fort James Fiber Company, and Fort James International Holdings, Ltd. (collectively, "Fort James") to dismiss,

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[1] Plaintiffs refer to Crown Vantage, Inc. ("Crown Vantage") and Crown Paper Company ("Crown Paper") "interchangeably" and "collectively" as "Crown," except where necessary to differentiate between the two entities. (*See* FJ FAC ¶ 4; PWC FAC ¶ 21.) For the purposes of this order, the Court will refer to plaintiffs as "Crown," except where necessary to differentiate between them.

pursuant to Rules 12(b)(6) and 9(b) of the Federal Rules of Civil Procedure, the FJ FAC. Also before the Court are five motions to dismiss, pursuant to Rules 12(b)(6) and 9(b), the PWC FAC, filed, respectively, by the following defendants: (1) McGuire Woods LLP, as successor to McGuire Woods Battle & Boothe, LLP ("McGuire Woods"); (2) Merrill Lynch & Co., Merrill Lynch Pierce Fenner & Smith, (collectively, "Merrill Lynch") and Salomon Brothers ("Salomon"); (3) Houlihan Lokey Howard & Zukin ("Houlihan Lokey"); (4) Ernest Leopold ("Leopold"), William Daniel ("Daniel"), Joseph T. Piemont ("Piemont"), and E. Lee Showalter ("Showalter"); and (5) Clifford Cutchins ("Cutchins"), Stephen Hare ("Hare"), and Robert C. Williams ("Williams"). Each of the above-referenced motions addresses Crown's claims based on conduct occurring after JRC was no longer Crown's sole shareholder. Additionally, before the Court are the deferred portions of three motions to dismiss, filed, respectively, by (1) PricewaterhouseCoopers LLP, f/k/a Coopers & Lybrand ("PWC"); (2) Ernst & Young LLP ("E & Y"); and (3) Credit Suisse First Boston Corporation, as successor to Donaldson, Lufkin & Jenrette ("DLJ"), *i.e.*, the portions addressing claims based on conduct after JRC was no longer Crown's sole shareholder.

*2 Having considered the papers filed in support and in opposition to the motions, the Court deems the matters appropriate for decision thereon, VACATES the hearing scheduled for July 13, 2004, and rules as follows.

FACTUAL BACKGROUND

Crown's claims arise out of a series of transactions, which Crown refers to as the "Spin," and from the aftermath of those transactions. In the pleadings, Crown defines the "Spin" as "a scheme by Fort James [ ] to unload vastly over-valued but under-performing assets onto Crown, and to cause Crown to borrow well over half a billion dollars, all of which monies were then taken by Fort James, while Crown remained obligated to pay on the loans." (*See* FJ FAC ¶ 627; *see also* PWC FAC ¶¶ 12-17.)[2]

The following facts, taken from the FJ FAC and from the PWC FAC, are assumed true solely for the purposes of the motions to dismiss:[3]

Prior to the transactions comprising the Spin, JRC, defendant Fort James' predecessor, was Crown's sole shareholder. (FJ FAC ¶¶ 249-50, 260(a); PWC FAC ¶¶ 254-55, 265(a).)[4] After the transactions comprising the

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[2] At a hearing conducted on August 15, 2003, Crown expanded on its definition of the Spin by explaining that, in its view, the Spin consisted of four transactions, occurring when: (1) JRC transferred assets and liabilities to Crown Paper, in exchange for Crown Paper stock; (2) Crown Paper borrowed money from third parties; (3) JRC obtained from Crown Vantage pay-in-kind notes; and (4) Crown transferred cash to JRC.

[3] The Court, in setting forth the background facts, has focused on the allegations concerning behavior occurring after JRC was no longer Crown's sole shareholder. The Court's order of September 25, 2003 contains a more detailed description of the alleged conduct occurring during the period in which JRC was Crown's sole shareholder.

[4] More specifically, Crown Vantage was a "publicly traded holding company owning 100% of Crown Paper's outstanding stock," (PWC

Spin, JRC distributed "all of the outstanding shares of Crown Vantage to the JRC shareholders," which was the first time there existed a "public market" for Crown stock. (FJ FAC ¶¶ 257, 260(o); PWC FAC ¶ 262, 265(o).) After the stock distribution, JRC continued to "exercise[ ] adverse dominion and control" over the Crown directors, and the "vestiges of JRC's control of Crown continued through and up to the time Crown filed for bankruptcy." (FJ FAC ¶¶ 346, 389; PWC FAC ¶¶ 351, 394.) JRC, assisted by the other defendants, "continued to misrepresent and/or conceal Crown's true financial condition ... long after Crown became insolvent." (FJ FAC ¶ 389; PWC FAC ¶ 394.) The "concealment of Crown's true financial condition artificially prolonged the life of Crown while giving the illusion ... that Crown's business was prosperous when, in fact, it was not." (FJ FAC ¶ 393; PWC FAC ¶ 398.)

Defendant McGuire Woods, a law firm who represented Crown, concealed from Crown after the Spin "all documents and information related to the Spin." (FJ FAC ¶ 350; PWC FAC ¶ 355.) Defendants Merrill Lynch and Houlihan Lokey, after the transfers, provided "false and misleading opinions" that the Spin had been "fair and equitable and not a fraudulent transfer." (FJ FAC ¶ 351; PWC FAC ¶ 356.) Defendant PWC prepared and disseminated "false and misleading financial statements" to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life." (FJ FAC ¶ 489; PWC FAC ¶ 494.) Defendant Salomon, who "conducted due diligence regarding Crown's post-

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¶ 3), and JRC was the "sole shareholder" of Crown Vantage, (FJ FAC ¶¶ 260(a), 630; PWC FAC ¶ 265(a)).

Spin operations," did not advise Crown of "the true nature of the assets." (FJ FAC ¶¶ 357-58; PWC FAC ¶¶ 362-63.) DLJ, defendant Credit Suisse First Boston Corporation's predecessor, who was Crown's financial advisor beginning in 1997, did not advise Crown of the true value of its assets and should have advised Crown to file for bankruptcy, rather than to continue as a "going concern." (FJ FAC ¶¶ 360, 379-80; PWC FAC ¶¶ 365, 384-85.)

*3 Defendant E & Y, an accounting firm that began performing services for Crown after the Spin, prepared audits for Crown that falsely represented Crown's financial position. (FJ FAC ¶¶ 20, 538; PWC FAC ¶¶ 23, 543.) In particular, E & Y "intended to hide the fact" that other defendants had "failed to properly write-down" the value of certain assets. (FJ FAC ¶ 608; PWC FAC ¶ 612.) Defendant Showalter, a Crown director, worked with E & Y to approve each of E & Y's audits of Crown so as "to conceal Crown's deepening insolvency, to hide the over-valuing of the transferred assets and to conceal his wrongdoing and that of [the other] Defendants." (FJ FAC ¶¶ 30, 436; PWC FAC ¶¶ 33, 441.) Defendants Daniel and Piemont, both of whom were Crown directors, had "conflicts of interest at the time of the Spin" and failed thereafter to take any steps to "remedy the Spin." (FJ FAC ¶¶ 442-43; PWC FAC ¶ 447-48.) Defendant Leopold, a Crown director, defendant Williams, JRC's President and CEO, and defendants Cutchins and Hare, both JRC Senior Officers, all "were aware of Crown's insolvency, under capitalization, its inability to pay debts as they matured and the fraudulent nature of the [ ] transfers," but failed to disclose such information to Crown after the Spin. (FJ FAC ¶¶ 341-43; PWC FAC ¶¶ 346-48.)

On March 18, 1998, JRC and Crown entered into an Option and Settlement Agreement, under which Crown's obligations to JRC were modified and Crown released any "potential claims arising out of the Spin" that Crown had against JRC and certain "generically described parties." (FJ FAC ¶¶ 323-24, 333; PWC FAC ¶¶ 328-39, 338.) "Crown received nothing in return for the release of claims." (FJ FAC ¶ 335; PWC FAC ¶ 340.)

Showalter, in his capacity as a Crown director but acting in the best interest of JRC, voted to approve the Option and Settlement Agreement. (FJ FAC ¶ 438; PWC FAC ¶ 443.) Piemont and Daniel voted to approve the Option and Settlement Agreement even though it provided no benefit to Crown. (FJ FAC ¶ 443; PWC FAC ¶ 448.) Leopold signed the Option and Settlement Agreement on behalf of Crown, thereby "potentially absolve[ing] JRC of any liability for certain prior wrongful acts done to Crown," even though Leopold had, four months earlier, stated to JRC that one of the Spin transactions had been "a one-sided deal, drafted only in favor of JRC." (FJ FAC ¶¶ 431-32; PWC FAC ¶¶ 436-37.) E & Y, knowing there was "no economic justification" for the Option and Settlement Agreement, "failed to identify, record, or disclose that the Agreement was absent arms length fairness or proper consideration." (FJ FAC ¶¶ 517-18; PWC FAC ¶¶ 522-23.) DLJ advised Crown to enter into the Option and Settlement Agreement in order to "protect" JRC and other defendants from liability as a result of the Spin. (FJ FAC ¶¶ 386-87; PWC FAC ¶¶ 391-92.)

On March 15, 2000, Crown, having "become insolvent by well in excess of $1 Billion," filed for bankruptcy protection. (FJ FAC ¶ 13.)

LEGAL STANDARD

*4 A motion to dismiss under Rule 12(b)(6) cannot be granted unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *See Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). Dismissal can be based on the lack of a cognizable legal theory or the absence of sufficient facts alleged under a cognizable legal theory. *See Balistreri v. Pacifica Police Dep't*, 901 F.2d 696, 699 (9th Cir. 1990). In analyzing a motion to dismiss, the court must accept as true all material allegations in the complaint and construe them in the light most favorable to the nonmoving party, *see NL Industries, Inc. v. Kaplan*, 792 F.2d 896, 898 (9th Cir. 1986), and may take judicial notice of matters of public record, *see Lee v. City of Los Angeles*, 250 F.3d 668, 688-89 (9th Cir. 2001).

DISCUSSION

Defendants argue that the remaining claims in the FACs should be dismissed on numerous grounds. The primary issue[5] is whether Crown has stated any viable claims against defendants based on conduct occurring on or after August 25, 1995.[6] Other than the claims brought on

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[5] The only other issues pertain to plaintiffs' two counts filed in the Crown Vantage case and brought on behalf of creditors.

[6] In its prior order, the Court noted that although the FACs do not state the date on which JRC ceased being Crown's sole shareholder, a judicially-noticeable document indicated Crown stock began trading on NASDAQ as of August 28, 1995. (*See* Order of September 25, 2003 at 6:26-28.) Crown now requests, and no defendant has opposed, the Court take judicial notice of an SEC filing indicating

behalf of creditors, all of plaintiffs' remaining claims arise from plaintiffs' allegations that defendants, acting on their own, as members of a conspiracy, and/or as aiders and abetters of other defendants, (1) engaged in various acts in an effort to prevent Crown from learning the truth about the fraudulent "Spin" transactions and/or otherwise caused Crown's deepening insolvency, and (2) caused Crown, in 1998, to enter into the Option and Settlement Agreement that itself constituted a fraudulent transaction.[7]

A. Effect of Imputation

In its prior order, the Court found that plaintiffs' claims brought on behalf of Crown are barred by the doctrine of in pari delicto, to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder. Under the doctrine of in pari delicto, the acts of a corporation's agents taken at the behest of the

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JRC distributed "all of the common stock of [Crown]" to third parties on August 25, 1995. (*See* Loeb Decl. Ex. 8.) It would thus appear that JRC ceased being Crown's sole shareholder on August 25, 1995, (*see id.*), and the new shareholders were able to publicly trade the shares as of August 28, 1995.

[7] The FACs unambiguously allege that the fraudulent conveyances comprising the Spin occurred while Fort James was the sole shareholder of Crown. (*See* FJ FAC ¶¶ 257, 260(o); PWC FAC ¶¶ 262, 265(o).) Plaintiffs now assert that, after having conducted further investigation, they discovered one of the Spin transactions, a transfer of approximately $484,900,000 from Crown to Fort James, occurred on August 28, 1995, *i.e.*, after Fort James was no longer Crown's sole shareholder. Because this assertion is not included in the FACs and, indeed, is at odds with the allegations in the FACs, the Court will consider plaintiffs' arguments with respect to the $484,900,000 transfer only in determining whether leave to amend is proper.

corporation's sole shareholder are imputed to the corporation, even if the acts could be considered adverse to the corporation. "In explaining the bases for this result, the Second Circuit has stated: 'This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal. Where, as here, a sole shareholder is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply.'" (*See* Order of September 25, 2003 at 15:12-17 (quoting *Mediators, Inc. v. Manney (In re Mediators)*, 105 F.3d 822, 827 (2nd Cir. 1997).) In the instant case, as a result of the doctrine of in pari delicto, Crown is deemed to have known the details of the Spin transactions, for example, that it received form JRC "heavily depreciated, overvalued and in some case environmentally contaminated assets" and "enormous liabilities" that left Crown "fatally wounded." (*See* FJ FAC ¶ 13).

*5 Defendants argue that the knowledge imputed to Crown while it was owned by JRC remains within the knowledge of Crown after JRC distributed its shares to third parties. As a consequence, defendants argue, plaintiffs' post-Spin claims fail because the success of such claims depends upon Crown lacking knowledge of the details of the Spin transactions. (*See* Defs.' Joint Memo. In Support of Mots. to Dismiss Post-Spin Claims at 11:4-12:13.) For example, defendants argue, plaintiffs cannot establish that Crown justifiably relied on post-Spin "false" statements or was injured by omissions concerning the value of assets transferred to Crown during the Spin

transactions[8] because Crown, as a consequence of its imputed knowledge, knew the truth about the assets transferred to it during the Spin transactions.

Plaintiffs, in opposition, do not argue that any post-Spin claims would be valid if the knowledge imputed to Crown while wholly owned by JRC remains imputed to Crown after JRC distributed Crown shares to third parties. Rather, plaintiffs argue that the knowledge imputed to Crown while JRC was Crown's sole shareholder does not continue to be imputed to Crown after JRC was no longer Crown's sole shareholder.

Because a corporation can only act through individuals, "[a] corporation's 'knowledge' can only be that of those individuals whose personal knowledge may be legally imputed to it." *See J.W. Woolard Mechanical & Plumbing, Inc. v. Jones Development Corp.*, 235 Va. 333, 367 S.E.2d 501 (Va. 1988).[9] The knowledge of a

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[8] *See, e.g.*, PWC FAC ¶¶ 362, 362 (alleging Salomon, in 1996, conducted "due diligence regarding Crown's post-Spin operations" and did not inform Crown of the "true nature of the assets which had been spun or of JRC's motivations in divesting the assets for cash").

[9] The Court, in its previous order, found Virginia law governs plaintiffs' claims against Fort James, PWC, McGuire Woods, Merrill Lynch, Salomon, DLJ, Leopold, Cutchins, Hare, Williams, Daniel, Piemont, Showalter, and, with the possible exception of one claim governed by New York law, Houlihan Lokey. (*See* Order of September 25, 2003 at 13:3-13, 20:18--21:7.) The Court further found New York law governs the contract-based claims against DLJ, (*see id.* at 22:10-11), and that California law governs the contract-based claims against E & Y, (*see id.* at 13:14-16), but did not reach the issue of whether non-contract based claims against DLJ and E & Y are governed by Virginia law, as plaintiffs appeared to contend at the hearing conducted September 25, 2003. Thus, all remaining

corporation's sole shareholder is legally imputed to the corporation. *See National Carloading Corp. v. Astro Van Lines, Inc.*, 593 F.2d 559, 562 (4th Cir. 1979) (applying Virginia law; holding where individual who was sole shareholder of two corporations caused one corporation to transfer its only valuable asset to the other corporation, corporations "had notice of this state of facts").

As noted, the parties disagree as to whether a corporation's knowledge remains imputed to the corporation after the corporation is purchased by new owners who are unaware of the imputed information. Where courts have considered this question, they have found that a corporation retains its imputed knowledge even after a change in ownership. As stated in one such opinion, in which the court applied the law of New Jersey and relied on the common law of both New Jersey and New York, "[t]he process of acquisition simply does not sanitize the acquired corporation, notwithstanding [ ] the fact that it has gained new owners and fresh management." *See Fireman's Fund Ins. Cos. v. Meenan Oil Co.*, 755 F. Supp. 547, 553 (E.D.N.Y. 1991) (holding corporation's claim against insurance policy barred under exclusion for "expected" damage, where corporation's prior owners knew corporation's underground oil facility was leaking; holding corporation deemed to have such knowledge even after corporation purchased by new owners; stating corporation's knowledge not "erased" after purchase by new owners). Similarly, in *Alice Roofing & Sheet Metal Works, Inc.*,

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claims are governed by Virginia, New York, or California law. No party has argued that the Court's resolution of the issues now before it would vary dependent on which state's law is applied.

775 S.W.2d 869 (Tex. App. 1989), the court, applying Texas common law, held that "later-acquired knowledge by new and subsequent corporate shareholders and officers does not constitute new knowledge to the corporate entity." *See id.* at 870 (holding where new owners of corporation discovered former sole shareholder used corporate funds for personal use, corporation's suit against former sole shareholder barred under statute of limitations because corporation deemed to have knowledge of sole shareholder's acts when they occurred);[10] *see also* 3 Fletcher Cyc. Corp. § 801 (1999) ("The rule is that a corporation, being once charged with notice of the character of a transaction, continues to be affected by such notice whatever changes may occur in the personnel of its working force.").

***6** Plaintiffs, in support of their argument that the above principles are inapplicable to the instant action, argue at length that defendants' post-Spin knowledge and actions cannot be imputed to Crown under the doctrine of in pari delicto or otherwise. According to plaintiffs, "After [JRC] ceased being Crown's sole shareholder, Crown became legally incapable of actively participating in its own wrongdoing (through agency principles)[;] [t]he 'sole actor' exception disappeared, and Crown's allegations of adverse interest prevent imputation after that time." (*See* Pls.' Consolidated Response in Opp. to Defs.' Mots. to Dismiss at 2:18-22.) Plaintiffs also contend that the Court decided this issue adverse to defendants when the Court,

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[10] The Fifth Circuit, in discussing *Alice Roofing*, has acknowledged the holding therein as reflecting a "general rule of imputation." *See Federal Deposit Ins. Corp. v. Shrader & York*, 991 F.2d 216, 222 (5th Cir. 1993).

in a section of its prior order titled "Application of In Pari Delicto Defense," stated, "In light of Crown's allegations that JRC was not Crown's sole shareholder after the completion of the transactions that comprised the Spin, however, and the allegations that the independent board members could have taken steps to remedy the alleged wrongdoing by defendants, defendants are not entitled to dismissal of Crown's claims to the extent the claims are based on conduct occurring after JRC was no longer Crown's sole shareholder." (*See* Order of September 25, 2003 at 18:6-11.) These arguments, however, misconstrue the issue now being raised by defendants. Defendants do not contend that any of defendants' post-Spin knowledge or conduct is properly imputed to Crown; rather, defendants argue that Crown's knowledge concerning the details of the Spin transactions, imputed to Crown while Crown's agents were acting at the behest of Crown's sole shareholder, remains imputed to Crown after the Spin transactions.

Plaintiffs also assert that courts have "refus[ed] to impute knowledge to an innocent successor corporation." (*See* Pls.' Consolidated Response in Opp. to Defs.' Mots. to Dismiss at 10:25-26.) The cases plaintiffs cite for this proposition, however, hold that the conduct of the corporation's agent at issue therein was not properly imputed to the corporation at any time. *See Ash v. Georgia-Pacific Corp.*, 957 F.2d 432, 436 (7th Cir. 1992) (holding knowledge of plaintiff's chief operating officer not imputed to plaintiff where chief operating officer acted "adversely to his employer"); *In re Cendant Corp. Sec. Litig.*, 139 F. Supp. 2d 585, 597-98 (D.N.J. 2001) (holding actions of plaintiff's agents not properly imputed to plaintiff where agents' actions were "against the best interests of the company"); *Battenfeld of America Holding*

Co. v. Baird, Kurtz & Dobson, 60 F. Supp. 2d 1189, 1194, 1217 (D. Kan. 1999) (holding fraudulent actions taken by plaintiff corporation's chief financial officer not imputed to plaintiff because conduct was "adverse[ ] to the interest" of plaintiff at time conduct occurred). None of the cases on which plaintiffs rely involves the situation where a sole shareholder directed the agents of a corporation it wholly owned to participate in a fraud. In any event, the cited cases do not consider the relevant issue of whether knowledge, once properly imputed to a corporation, disappears after the corporation is purchased by "innocent" parties; thus, they are inapposite.

*7 In short, plaintiffs cite no authority for the proposition that a corporation, after its ownership is transferred to new parties, is no longer bound by knowledge it acquired before the transfer. Although no party has offered any Virginia law directly bearing on this issue,[11] the Court finds no basis on which to conclude the highest court of Virginia, as well as the highest courts of the states of California and New York, would hold that a corporation's imputed knowledge is erased when the corporation is sold to new owners who, in their individual capacities, lack

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[11] To the extent the Supreme Court of Virginia has ruled on a related issue, such ruling appears consistent with the Court's decision herein. In particular, the Supreme Court of Virginia, applying the "general rule, that a party who consents to and participates in an immoral or illegal act cannot recover damages from other participants for the consequence of that act," has held that an executor of the estate is barred from recovery if the decedent would have been barred. *See Miller v. Bennett*, 190 Va. 162, 56 S.E.2d 217, 218, 221 (1949). In other words, under Virginia law, a decedent's conduct is imputed to the executor, even though the executor had no involvement in or knowledge of the illegal activity.

such knowledge. Consequently, defendants are entitled to dismissal of plaintiffs' remaining claims, to the extent such claims are dependent on a showing that defendants failed to disclose certain facts, where knowledge of such facts was earlier imputed to Crown during the time JRC was Crown's sole shareholder.

As noted, defendants assert that all remaining claims brought on behalf of Crown are based on Crown's lack of knowledge of the true nature of the Spin transactions, and plaintiffs, in their opposition, have not taken issue with this assertion. Consequently, the remaining claims, with the exception of the two counts brought on behalf of creditors in the Crown Vantage case, are subject to dismissal.

The Court next turns to the question of whether plaintiffs should be afforded an opportunity to amend. Plaintiffs, in an appendix attached to their opposition, have submitted a proffer setting forth additional details concerning defendants' conduct after the Spin transactions. For example, plaintiffs state they are prepared to allege that JRC, Williams, and Hare, when writing a letter to PWC in September 1995, falsely stated that "Crown's pre-Spin financial statements were correct," (*see* Appendix A to Pls.' Consolidated Response in Opp. To Defs.' Mots. To Dismiss Post-Spin Claims ¶ 6), that PWC "sought to hide the fraudulent nature of the Spin" when it prepared a memorandum for Crown in October 1995, (*see id.* ¶ 9), that McGuire Woods, during the period of 1996 through 1999, provided "audit response letters" to Crown in which McGuire Woods "failed to disclose ... that Crown had been the victim of fraud in the Spin transactions," (*see id.* ¶ 19), and that Leopold, when drafting a letter on August 25, 1995, had an "appropriate opportunity" to

"disclose the truth about what he knew about the [Spin] transactions," but instead he "said nothing," (*see id.* ¶ 23). Leave to amend to allege such additional facts, as well as similar assertions set forth by plaintiffs in their proffer, would be futile because the success of such claims is dependent on Crown being ignorant of the "truth" of the Spin transactions. As discussed above, the knowledge imputed to Crown while JRC was its sole shareholder remains imputed to Crown in the post-Spin period. Accordingly, leave to amend to allege the information set forth in plaintiffs' proffer will be denied.

*8 Additionally, as noted, *see, supra*, n. 7, plaintiffs now assert, in contradiction to the allegations in the FAC, that one of the cash transfers from Crown to JRC comprising the Spin occurred shortly after JRC transferred its Crown shares to third parties. Specifically, plaintiffs now assert Crown transferred the funds at issue into an escrow account while JRC was Crown's sole shareholder, the actual transfer from the escrow agent to JRC occurring shortly after JRC transferred its Crown shares to third parties. Assuming, *arguendo*, the relevant date is the date JRC took possession of the funds from the escrow officer, Crown, before that date, knew such transaction was, as Crown has alleged, "fraudulent," (*see* FJ FAC ¶ 13; PWC FAC ¶¶ 16-17), because, according to Crown, such transaction was undertaken by Crown's agents, and others, at the behest of Crown's sole shareholder.

Finally, the Court notes that in its previous order, the Court dismissed three of plaintiffs' claims, specifically, claims for negligent misrepresentation against, respectively, Fort James, Merrill Lynch, and Salomon, with leave to amend in order to afford plaintiffs the opportunity to clarify that such claims are based on a

theory of constructive fraud and to the extent such claims are based on conduct occurring after JRC was no longer Crown's sole shareholder. (*See* Order of September 25, 2003 at 21:19--22:1.) In light of the above discussion, however, leave to amend for such purpose would be futile, and, consequently, that part of the Court's prior order is hereby VACATED.

Accordingly, plaintiffs' remaining claims, with the exception of the two counts brought on behalf of creditors in the Crown Vantage case, will be dismissed without leave to amend. As discussed, amendment would be futile in that, as a matter of law, the knowledge imputed to Crown while Crown was wholly owned by JRC remained imputed to Crown although JRC no longer was the sole shareholder.[12]

B. Fraudulent Conveyance Claims

The remaining claims in these consolidated proceedings are Counts 1 and 2 of the Crown Vantage case, both of which are fraudulent conveyance claims brought pursuant to 11 U.S.C. § 544(b) against Fort James and on behalf of creditors. In Count 1, plaintiffs seek to set aside the Spin transactions and, in Count 2, plaintiffs seek to set aside the 1998 Option and Settlement Agreement.

"[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor." 11

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[12] In light of this finding, the Court does not address defendants' additional arguments pertaining to the remaining claims brought on behalf of Crown.

U.S.C. § 544(b). "Applicable law" within the meaning of § 544(b) includes state law. *See Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 593 (9th Cir. 1991). The parties submit, and the Court agrees, that Virginia law governs Counts 1 and 2. Under Virginia law, a transfer "given with intent to delay, hinder or defraud creditors, purchasers or other persons of or from what they are or may be lawfully entitled to shall, as to such creditors, purchasers or other persons, their representatives or assigns, be void," *see* Va.Code Ann. § 55-80, and a transfer "which is not upon consideration deemed valuable in law ... by a transferor who is thereby rendered insolvent, shall be void as to creditors whose debts shall have been contracted at the time it was made ...," *see* Va.Code. Ann. § 55-81.

***9** Fort James argues that the two fraudulent conveyance claims are subject to dismissal.

1. Identification of Creditors

Fort James argues that plaintiffs fail to state a claim for fraudulent conveyance because plaintiffs cannot establish there are any creditors whose claims against Crown existed at the time of the conveyances plaintiffs now seek to set aside.

"Federal courts applying fraudulent transfer law at the pleading stage generally require that the complaint allege the existence of an actual creditor holding an allowable unsecured claim who could avoid a transfer under applicable state law in the absence of a bankruptcy proceeding." *Neilson v. Union Bank of California, N.A.*, 290 F. Supp. 2d 1101, 1146 (C.D. Cal. 2003) (citing cases). "Courts are divided, however, as to whether a

complaint must specifically allege the identity of the creditor to state a claim under § 544(b)." *Id.* at 1147 (citing conflicting holdings in district court cases).

Assuming, *arguendo*, a plaintiff should be required to specifically allege the identity [sic] of a creditor whose claim existed at the time of the alleged fraudulent conveyance, here, plaintiffs have specifically alleged, in Count 1, the identity of creditors whose claims existed at the time of the Spin transactions, (*see* FJ FAC ¶ 720), and, in Count 2, the identity of creditors whose claims existed at the time Crown entered into the Option and Settlement Agreement, (*see* FJ FAC ¶ 745 (incorporating by reference ¶ 720)). Fort James, however, asserts that the allegations supporting Count 1 are "at war with the facts." (*See* Fort James' Mot. To Dismiss at 24:21-22.) Requesting that the Court take judicial notice of the claims filed in the bankruptcy court by the identified creditors, (*see* Coyne Decl. Ex. 4-12), Fort James argues that each identified creditor alleges a claim that arose on a date after August 1995. Consequently, Fort James contends, because no creditor has a claim against Crown that existed on August 25, 1995, the date plaintiffs assert the Spin transactions were complete, (*see* FJ FAC ¶¶ 248-254), the claims of the identified creditors do not support Count 1.[13]

Plaintiffs do not oppose the Court taking judicial notice of the claims filed by the creditors. Plaintiffs, however, argue that Fort James' interpretation of the claims is not supported by a review thereof. The Court agrees. For

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[13] With respect to Count 2, Fort James argues that plaintiffs have not identified any creditors. This is incorrect, as plaintiffs have pointed out by referring Fort James to ¶ 745 of the FJ FAC.

example, the Tennessee Department of Revenue, in a box on the claim form in which it was asked to identify the "date debt was incurred," wrote "06/95--03/00," (*see* Coyne Decl. Ex. 10 at 254), which is sufficient to allege that, in the creditor's view, some amount of the debt Crown owes to the creditor was incurred on or before August 25, 1995. As another example, the Environmental Protection Agency alleges that its claim against Crown is based in part on Crown's "manufactur[ing] manganese during the calendar years 1995 and 1996," (*see* Coyne Decl. Ex. 4 at 177); there is no language in the claim from which the Court could, in the context of a motion to dismiss, definitively conclude any such claim arose after August 25, 1995. Similarly, the claims submitted, respectively, by American Express Financial Corporation and Alliance Capital Management, L.P., indicate that each of those two creditors seeks to recovery on a debt incurred in "August 1995," (*see* Coyne Decl. Exs. 11, 12); neither claim includes language indicating that such claim was incurred after August 25, 1995.

***10** Accordingly, as the Court cannot conclude from the judicially-noticeable documents that plaintiffs are unable to establish the existence of creditors whose claims against Crown had accrued as of the time of the conveyances plaintiffs seek to set aside, Fort James is not entitled to dismissal of Counts 1 and 2 on this ground.

2. Settlement Agreement and Release

Fort James, relying on plaintiffs' allegation that Crown entered into the Option and Settlement Agreement with JRC, argues that the agreement should be interpreted as releasing JRC from the claims alleged in Counts 1 and 2. Assuming, *arguendo*, the agreement is enforceable, Fort

James points to no language in the agreement that could be construed as releasing JRC from any claims held by creditors. Moreover, Fort James fails to explain how the creditors, who were not parties to the Option and Settlement Agreement, could be bound by the agreement.

Accordingly, Fort James is not entitled to dismissal of Counts 1 and 2 based on the Option and Settlement Agreement between Crown and JRC.

3. Consideration Deemed Valuable in Law

Fort James argues plaintiffs cannot establish that Crown, when it transferred assets to JRC, failed to receive "consideration deemed valuable in law." *See* Va.Code Ann. § 55-81. In making this argument, Fort James seeks, in effect, a ruling limiting Counts 1 and 2 to claims that the conveyances were "given with intent to delay, hinder or defraud creditors," as is required under § 55-80.

Under § 55-81, "a transfer undertaken by an insolvent debtor, or by a debtor who is thereby rendered insolvent, without return to him of valuable consideration is *de jure* fraudulent as against any existing creditor without any need to prove intent to defraud." *See Balzer & Associates, Inc. v. Lakes on 360, Inc.*, 250 Va. 527, 463 S.E.2d 453, 455 (Va.1995) (emphasis in original). "A valuable consideration is said to be a benefit to the party promising, or to a third person at his request, or an inconvenience, loss, or injury, or the risk of it, to the party promised." *White v. Allegahny Mountain Corp.*, 159 Va. 394, 401-02, 165 S.E. 505 (Va.1932) (internal quotation and citations omitted).

a. Count 1

In Count 1, plaintiffs seek to set aside the conveyances Crown made to JRC that occurred during the Spin, which, according [sic] to the FAC, were transfers of monies totaling $551,200,000. (*See* FJ FAC ¶ 651(f).)

Fort James argues that plaintiffs have alleged JRC transferred assets such as paper [sic] mills to Crown in exchange for the transfers of monies, and, consequently, that plaintiffs have alleged there was valuable consideration to support the conveyances. As plaintiffs point out, however, they have actually alleged that the transfers of monies from Crown to JRC constituted a return of capital and not an exchange of monies for assets. Specifically, plaintiffs allege that Crown transferred the sum of $551,200,000 to JRC "without consideration," and that the transfers constituted a "return of the capital investment of JRC." (*See* FJ FAC ¶¶ 252, 256.) Additionally, plaintiffs allege that JRC transferred the paper mills and other assets to Crown in exchange for 100% of Crown's common stock, (*see* FJ FAC ¶¶ 250, 651(c)), and that JRC reported to the Internal Revenue Service that such transaction "was not a 'sale' of assets to Crown," (*see* FJ FAC ¶ 256).

***11** In its reply in support of its motion to dismiss, Fort James, relying on a California Court of Appeal opinion applying California law, argues that a return of capital constitutes valuable consideration if the transfer benefits the transferor corporation. *See Annod Corp. v. Hamilton & Samuels*, 100 Cal.App. 4th 1286 (2002). Assuming, *arguendo*, Fort James' interpretation of *Annod Corp.* is correct and that the highest court of Virginia would adopt the reasoning stated therein, here, plaintiffs' FAC cannot

be reasonably interpreted as alleging Crown's transfer of $551,200,000 to JRC benefited Crown. Rather, the FAC expressly alleges to the contrary by stating that Crown, after transferring the $551,200,000 to JRC, was "unable to pay debts as they came due and [was] without sufficient liquidity, capital, and assets to operate profitably as a going concern." (*See* FJ FAC ¶ 260(1).)[14]

Consequently, the Court cannot find, from the face of the complaint, that Crown's transfer of $551,200,000 to JRC was for consideration deemed valuable in law. Accordingly, Fort James is not entitled to dismissal of Count 1 based on a failure to allege the subject conveyances were not upon consideration deemed valuable in law.

b. Count 2

In Count 2, plaintiffs seek to set aside the conveyance Crown made to JRC under the Option and Settlement Agreement, specifically the release granted by Crown to JRC thereunder.

Fort James, requesting the Court take judicial notice of the Option and Settlement Agreement,[15] argues the face of

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[14] Fort James also argues that the Court should reject plaintiffs' characterization of the Spin transactions and instead find that JRC transferred assets in return for the $551,200,000. This argument, made in the context of a motion to dismiss, is premature.

[15] Plaintiffs do not oppose the Court's taking judicial notice of the Option and Settlement Agreement and, indeed, rely on statements in the Option and Settlement Agreement in support of other arguments. (*See, e.g.*, Pls.' Mem. In Opp. To Separate Mot. Of Def. Fort James to Dismiss FAC at 12-13.)

the agreement establishes that in return for the release by Crown, JRC gave Crown consideration deemed valuable in law. Specifically, Fort James notes that under the Option and Settlement Agreement, JRC agreed to release Crown from some of Crown's obligations to JRC arising under agreements made during the Spin, such as Crown's obligation to make certain payments to JRC under the terms of "PIK Notes."[16] Plaintiffs, in opposition, argue that under Virginia law the forgiveness of an obligation owed under a fraudulently obtained agreement does not constitute consideration deemed valuable in law.

The Supreme Court of Virginia has stated that "the forbearance to prosecute an invalid, worthless or unfounded claim is not a consideration recognized by the law as valuable." *See Pierce v. Plogger*, 223 Va. 116, 286 S.E.2d 207, 210 (Va.1982) (quoting *Hoof v. Paine*, 172 Va. 481, 2 S.E. 2d 313, 314 (1939) (alteration in original). Examples of forbearance of "clearly unenforceable" claims, and hence not consideration deemed valuable in law, include "a promise to forbear from claims under an illegal contract, ... or one which is without consideration, or which is barred by the statute of limitations, or of the discontinuance of a vexatious lawsuit brought to harass ...." *See Hooff*, 2 S.E.2d at 314-15 (holding plaintiff's promise not to file mechanic's lien, where plaintiff had no right to file mechanic's lien, not valid consideration). In short, under Virginia law, "consideration fails if it be shown that the claim is wholly and certainly unsustainable at law or in equity." *See id.* at 315.

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[16] This is a reference to "Pay-in-Kind Notes" that Crown alleges JRC "forced" Crown to issue during the Spin. (*See* FJ FAC ¶ 252.)

*12 Here, plaintiffs allege that the Spin transactions, which include the agreements under which Crown became obligated to JRC and which are the focus of the Option and Settlement Agreement, constituted fraudulent conveyances. Although the Court, in its prior order, found that Crown itself was barred from recovering damages from Fort James based on conduct occurring while JRC was Crown's sole shareholder, the Court did not hold that plaintiffs had failed to allege that the conveyances were fraudulent as to third parties. In that plaintiffs' FAC alleges that the Spin agreements lacked valuable consideration, plaintiffs have sufficiently pleaded that any claim for breach of such agreements would be "wholly and certainly unsustainable at law or in equity."

Consequently, the Court cannot find, from the face of the complaint and judicially-noticeable documents, that JRC's promise to release Crown from certain of its obligations owed as a result of agreements entered into during the Spin constituted consideration deemed valuable in law. Accordingly, Fort James is not entitled to dismissal of Count 2 based on a failure to allege the release conveyed by Crown was not upon consideration deemed valuable in law.

4. Intentional Fraud

Fort James argues that Count 2, as a pleading matter, does not allege a claim of fraudulent conveyance on a theory of intentional fraud because plaintiffs do not allege the Option and Settlement Agreement was made with "intent to delay, hinder, or defraud creditors," *See* Va.Code Ann. § 55-80. Although plaintiffs argue that the subject complaint contains such an allegation, plaintiffs, in support of that argument, point to an allegation specific to

the Spin transactions only. (*See* FJ FAC ¶¶ 254, 258.) Plaintiffs, however, state in their opposition that "[a]ctual misrepresentations were made to Crown creditors to accomplish the [r]elease." (*See* Pls.' Mem. In Opp. To Separate Mot. Of Def. Fort James to Dismiss FAC at 17:3-5.) There being no reason to conclude that any such allegations, if made in the complaint, would be futile, the Court will afford plaintiffs the opportunity to amend Count 2 to clarify such count is based in part on a theory that the parties entered into the Option and Settlement Agreement with the intent to delay, hinder or defraud creditors.

CONCLUSION

For the reasons discussed above,

1. Defendants' motions to dismiss the First Amended Complaint in the Liquidating Trust case, *Crown Paper Liquidating Trust v. PricewaterhouseCoopers, et al.*, C 02-3836 MMC, are hereby GRANTED, and the First Amended Complaint in that action is hereby DISMISSED without leave to amend.

2. Fort James' motion to dismiss the First Amended Complaint in the Crown Vantage case, *Crown Paper Co., et al, v. Fort James Corp., et al.*, C 02-3839 MMC, is hereby GRANTED in part and DENIED in part, as follows:

a. Count 2 is dismissed, with leave to amend, to the extent it is based on a theory of intentional fraud.

***13** b. Counts 3 through 12 are dismissed without leave to amend.

c. In all other respects, the motion is denied.

d. Plaintiffs may file a Second Amended Complaint, no later than August 6, 2004, to cure the deficiency in Count 2 as set forth above.

This order closes Docket Numbers 88, 91, 93, 208, 210, 211, 213, 216, 226, and 278.[17]

IT IS SO ORDERED.

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[17] In light of the Court's issuance of the instant order, plaintiffs' motion to strike DLJ's proposed order is DENIED as moot.

APPENDIX D
FILED
SEP 20 2006
CATHY A. CATTERSON
CLERK, U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CROWN PAPER LIQUIDATING TRUST,

Plaintiff - Appellant,

PRICE WATERHOUSECOOPERS LLP; ERNST & YOUNG, LLP; MERRILL LYNCH & CO.; MERRILL, LYNCH, PIERCE FENNER & SMITH, SALOMON BROS.; DONALDSON, LUFKIN & JENRETTE; HOULIHAN LOKEY HOWARD & ZUKIN; CLIFFORD CUTCHINS; STEPHEN HARE, ERNEST LEOPOLD; E. LEE. SHOWALTER; ROBERT C. WILLIAMS; WILLIAM JAMES DANIEL; JOSEPH T. PIEDMONT; CREDIT SUISSE FIRST BOSTON LLC; FORT JAMES CORPORATION; FORT JAMES INTERNATIONAL HOLDINGS, LTD.; FORT JAMES OPERATING COMPANY; FORT JAMES FIBER CO.; MCGUIRE WOODS LLP,

Defendants – Appellees.

Before: T.G. NELSON, SILVERMAN, and RAWLINSON, Circuit Judges.

The panel has voted to deny the petition for rehearing. Judges Silverman and Rawlinson voted, and Judge T. Nelson recommended, to deny the petition for rehearing en banc.

The full court has been advised of the petition for rehearing en banc, and no judge of the court has requested a vote.

The petition for rehearing and rehearing en banc filed on August 23, 2006, is DENIED.

APPENDIX E

11 U.S.C. § 541. Property of the estate

(a) The commencement of a case under section 301, 302, of 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is –

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date –

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

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